

Conference Committee Agrees on Bill to Amend Bankruptcy Laws

Prepared by

Todd J. Zywicki

George Mason University School of Law

Co-Chair, Bankruptcy Practice Subcommittee, Financial Services and E-Commerce Practice Group



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In a surprise development late last week, House and Senate conferees reached agreement on a conference report on the Bankruptcy Reform Act. After narrow failures the past two Congresses, the bill now at last appears to be headed for passage into law. In the summer of 1998, a prior effort reached agreement between House and Senate conferees only to sink under the press of impeachment proceedings against President Clinton. A second bill actually passed both houses of Congress during the lame-duck session of December 2000, only to fall victim to a pocket veto by President Clinton. It appears the bill now is finally headed for passage. President Bush has indicated that he would sign it into law.

The bill would effect the most dramatic changes in the shape of American bankruptcy law since the enactment of the Bankruptcy Code in 1978. For the first time, it establishes a system of “means-testing” of individual bankruptcy filers for chapter 7 relief. Under current law, the individual debtor has the right to choose whether to file a petition under chapter 7 of the Bankruptcy Code or Chapter 13. Under Chapter 7, a debtor is expected to surrender all of his nonexempt assets to his creditors, and in exchange, is given a prompt discharge of all of his outstanding debts. In practice, however, through pre-bankruptcy planning most debtors can insure that few, if any, assets are actually made available to pay to unsecured creditors. Debtors have the unilateral power to convert nonexempt assets (such as bank accounts, stocks, and bonds) to exempt assets (such as annuities, retirement accounts, and homestead exemptions) on the eve of bankruptcy. In addition, the debtor has the power to consume and remaining nonexempt funds on goods and services prior to filing bankruptcy. Through some basic pre-bankruptcy planning, therefore, debtors can receive a discharge in Chapter 7 while surrendering few assets to creditors. In fact, empirical studies conclude that approximately 95% of Chapter 7 cases make no distribution to unsecured creditors, and the others distribute only trivial amounts.

The bankruptcy reform legislation, by contrast, institutes a system of means-testing eligibility for Chapter 7. It contemplates a simple three-step analysis, which if satisfied creates a presumption that the debtor must file in Chapter 13 and enter a repayment plan, rather than receiving a discharge in Chapter 7. Under the means-testing proposals of the legislation, the debtor must first make above the state median income, adjusted for family size. This will obviously differ from state to state (the median income is much higher in California than in Mississippi, for instance). To get a rough idea, however, the current national median income is approximately \$55,000 for a family of four. If the debtor earns less than the state median income, then he is excused from further application of the means-test, leaving him free to file Chapter 7 as under current law. It is estimated that approximately 80% of bankruptcy filers earn less than the median income, thus the means-testing portions of the bill would leave them unaffected. If a debtor earns more than the state median income, then the Court will apply the second stage of the analysis. Under this step the Court must determine whether the debtor could repay a substantial portion of his debts in a Chapter 13 plan. This is done by subtracting from the debtor’s income a standardized list of approved expenses that give allowances for living expenses such as food, housing, and clothing. Then, the debtor may also

subtract any actual payments on secured debts (such as car loans and home mortgages), an allowance for children's school expenses, and any actual medical expenses for the debtor or members of his family. After subtracting all of these expenses, if the debtor still has sufficient income left over to repay \$6,000 or more of his debts over a five-year Chapter 13 plan (or 25% of his unsecured debt, if the total amount is less than \$6,000), then the debtor would be presumed to have to file in Chapter 13, rather than Chapter 7. It is estimated that an additional 10% of bankruptcy filers lack the ability to repay a substantial portion of their debts, even though they make above the median income. As a final step in the inquiry, the debtor can still rebut this presumption by demonstrating to the Court that he faces significant hardships that would make it inequitable for him to file in Chapter 13, such as a substantial income reduction, incapacity, or unusual expenses not captured in the means-testing formula.

If all three elements of the test are met, the debtor would be required to file in Chapter 13 and to repay as much as his debts as possible. Although only 7-10% of bankruptcy filers would be steered toward Chapter 13 as the result of means-testing, by targeting high income bankruptcy filers it is estimated that this group of filers could repay some 65% of their unsecured debts, as opposed to the typical repayment of zero under current law. It is further estimated that this would result in the recovery of some \$3 billion-\$4 billion annually that is currently discharged in bankruptcy proceedings. Although it has been suggested that application of means-testing would create administrative difficulties, in fact several publishers have already designed computer worksheets to implement the means-testing proposals, including on-line versions of the software.

The bill also cracks down on many other forms of abuse and fraud by debtors. It creates several new mechanisms to increase accountability in bankruptcy proceedings, designed to limit the ability of debtors to conceal assets from their creditors and to defraud the bankruptcy court. This includes new requirements to increase verification of debtors' schedules. The bill also cracks down on bad-faith repeat filings and other fraudulent and abusive bankruptcy practices.

In addition, the bill adds several new safeguards to prevent abusive creditor practices. In particular, the bill adds further regulations limiting the availability of debtors to reaffirm unsecured debts.

The bill adds several new provisions to limit abusive practices by bankruptcy attorneys. In particular, the bill for the first time would require debtors to seek consumer credit counseling to try to craft a consensual repayment plan prior to filing for bankruptcy. Many bankruptcy filers today get information about bankruptcy from attorneys and attorney advertising. In practice bankruptcy debtors' attorneys have a substantial conflict of interest in advising clients, in that attorneys receive fees if the debtor files bankruptcy but do not if the debtor instead enters into a voluntary repayment plan with consumer credit counseling. This has led to a number of abuses by attorneys, but most fundamentally to stampeding debtors into bankruptcy filings when they would have been better served through a voluntary repayment plan. For the first time, the bankruptcy reform act requires credit counseling before filing bankruptcy.

Finally, the bill adds a number of new powers for marital support creditors to protect their rights in bankruptcy. Current bankruptcy law provides a number of traps for unwary and unsophisticated women seeking to enforce alimony, child support, and

property settlement judgments against bankruptcy debtors. The bankruptcy reform bill closes many of these loopholes and increases protection for marital support creditors. In addition, the reform bill elevates payment of alimony and child support obligations from seventh to first priority among administrative priorities in bankruptcy, supplanting attorneys' fees, which currently hold first priority. Ironically, bankruptcy professionals have nonetheless criticized the bankruptcy the reform bill as being detrimental to marital support creditors.

Although the bill is primarily concerned about consumer bankruptcy, it also creates a number of innovations related to business bankruptcy. In particular, the bill creates a new set of procedures designed to reduce the expense and delay associated with small business bankruptcies. Current law lacks effective procedures for insuring the timely resolution of bankruptcy cases involving small businesses, which as a result tend to sit in bankruptcy for years with little progress. Because of the small amounts at stake in such cases, creditors lack incentives to provide adequate oversight and to encourage a resolution of the case. The reform bill provides a number of new procedural mechanisms that are aimed at streamlining and simplifying resolution of these cases, thereby reducing the cost and delay currently occasioned by them.

In congressional negotiations, passage of the bill was delayed by the need to resolve a controversial and largely unnecessary amendment prohibiting the discharge of civil judgments arising from violations of the Freedom of Access to Clinic Entrances ("FACE") Act. Section 523(a)(6) of current law already prohibits discharge of debts arising from "willful and malicious injury" to the person or property of another. Caselaw has uniformly established that civil judgments arising from violations of the FACE Act constitute willful and malicious injury and are therefore nondischargeable. Although largely superfluous, therefore, Senator Charles Schumer has insisted on unique protections for these particular creditors. Negotiators finally reached a resolution on appropriate language that proved satisfactory to all conferees.

The resolution of the abortion issue comes on the heels of the resolution of the only other controversial issue, dealing with the unlimited homestead exemption. As finally drafted, a debtor would be required to wait for 40 months after moving to a state with an unlimited homestead exemption before she could avail herself of the unlimited homestead exemption. If the 40 month period had not yet passed, the debtor's homestead exemption would be capped at \$125,000 in equity in her house. In addition, the conferees added a so-called "Enron exception" which makes the homestead exemption ineffective against civil judgments arising from securities fraud. The clear intent of this provision was to prevent corporate executives residing in Texas and Florida from pouring assets into their homesteads and nonetheless discharging civil judgments arising from improper conduct.

The House had planned to vote on the conference bill last week before leaving town for August recess, but were unable to do so. It is now expected that the House pass the conference bill soon after returning after Labor Day. The Senate is expected to vote soon after the House acts. It is thus possible that the bill could be signed into law by the President by the time Congress recesses for the fall elections. Otherwise the bill will be part of the agenda of any lame-duck Congress that may convene in December. Previous versions of the bill passed by landslides in both houses of Congress. In voting in 2001, the bill passed the House by a vote of 306-108 and the Senate 83-15. The overwhelming

support for bankruptcy reform reflects the broad-based, bipartisan coalition of Republicans and moderate Democrats. By contrast, opposition to the bill has been largely relegated to bankruptcy lawyers who will suffer a financial loss as a result of the bill's probable effect of reducing bankruptcy filings, especially among high-income debtors and small businesses. On Capitol Hill, opposition to the bill has been spearheaded by Paul Wellstone and Edward Kennedy in the Senate and Jerrold Nadler in the House, all of whom are recipients of substantial campaign contributions from lawyers. In addition, bankruptcy professors and so-called "consumer advocate" groups have voiced opposition to the reform bill, primarily on ideological grounds. The primary beneficiaries of the reform will be unsecured creditors and the vast majority of consumers who pay their bills and do not file bankruptcy. After all, bankruptcy losses are a cost of business like any other cost of business, whether rent, utilities, taxes, or salaries. Thus, at least some of the losses under the current system are passed along to other consumers in the form of higher interest rates, higher penalty fees, higher downpayments, and higher prices for goods and services. Thus, despite the insistence of so-called "consumer advocate" groups, being pro-debtor is simply not the same as being pro-consumer, as consumers who pay their bills subsidize those who do not.

Although the bill might pass at any time before the end of the year, most of the provisions do not take effect until six months after the bill becomes law. The text of the bankruptcy reform bill and the Conference Report are available on the website of the American Bankruptcy Institute, at www.abiworld.org.