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Consumer Bankruptcy Reform: Proposals Before the 105th Congress

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Abstract

This report examines several proposals for consumer bankruptcy reform which have been introduced in the 105th Congress. In 1997, two bills — H.R. 2500 and S. 1301 — were introduced that would dramatically change the manner in which consumer bankruptcies are administered under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* On February 3, 1998, a successor bill to H.R. 2500 was introduced — H.R. 3150. This bill is far broader in scope and addresses many aspects of bankruptcy practice in addition to consumer reform.

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Consumer Bankruptcy Reform

Summary

Shortly before the close of the 1st Session of the 105th Congress, two bills — H.R. 2500 and S. 1301 — were introduced that would dramatically change the manner in which consumer bankruptcies are administered under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* On February 3, 1998, a successor bill to H.R. 2500 was introduced — H.R. 3150. This bill is far broader in scope and addresses many aspects of bankruptcy practice in addition to consumer reform.

Although the Senate and House bills differ significantly, they are referred to as being intended to effect “needs based” bankruptcy, *i.e.*, a consumer bankruptcy system that differentiates among debtors and, by application of external jurisdictional standards or through case-by-case scrutiny, ensures that unsecured creditors receive a higher distribution than they might otherwise.

To achieve this goal, these bills would require certain debtors to pledge future wages or income towards debt repayment under a chapter 13 consumer reorganization rather than having the option of liquidating under chapter 7. Hence, the bills introduce the concept of “mandatory reorganization” into a bankruptcy system that has been premised on *voluntary* debtor reorganization as an alternative to liquidation to obtain a bankruptcy discharge of indebtedness.

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Consumer Bankruptcy Reform: Proposals Before the 105th Congress

Introduction

Shortly before the close of the 1st Session of the 105th Congress, two bills — H.R. 2500¹ and S. 1301² — were introduced that would dramatically change the manner in which consumer bankruptcies are administered under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* On February 3, 1998, a successor bill to H.R. 2500 was introduced — H.R. 3150.³ This bill is far broader in scope and addresses many aspects of bankruptcy practice in addition to consumer reform.

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H.R. 3146, entitled the “Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998,” takes a very different approach to amending chapter 13.⁴ It would focus on creditor lending practices, particularly those of credit card lenders, by making it more difficult for unsecured lenders to collect certain debts under chapter 13. It also contains measures designed to prevent abusive chapter 7 filings by consumer debtors.

¹ H.R. 2500, 105th Cong., 1st Session (1997), the “Responsible Borrower Protection Bankruptcy Act.” (Introduced September 18, 1997 by Representatives McCollum and Boucher.)

² S. 1301, 105th Cong., 1st Session (1997). (Introduced October 21, 1997 by Senators Grassley and Durbin.)

³ H.R. 3150, 105th Cong., 2nd Session (1998). (Introduced by Representatives Gekas, McCollum, Boucher and Moran.)

⁴ H.R. 3146, 105th Cong., 2nd Session (1998). (Introduced February 3, 1998 by Representatives Nadler, Conyers and Hillard.)

This report examines current consumer bankruptcy practice and the proposals set forth in the reform bills. Also considered are the legislative history of the current consumer bankruptcy scheme, and topics likely to be debated as Congress proceeds to consider consumer bankruptcy reform.

Background

Current consumer bankruptcy practice. The current bankruptcy Code was enacted in 1978.⁵ It replaced and repealed in its entirety the pre-existing Bankruptcy Act of 1898.⁶ In 1970, when Congress perceived the need to modernize the bankruptcy laws, it created a Commission on the Bankruptcy Laws of the United States to study and recommend changes in the law. The Commission filed its final report with the Congress on July 30, 1973.⁷ In 1994, Congress created another commission, the National Bankruptcy Review Commission (NBRC), to study and report recommendations for legislative change. The NBRC issued its report on October 20, 1997.⁸ In a lengthy report of approximately 1300 pages, the Commission adopted as many as 172 recommendations dealing with, *inter alia*, consumer bankruptcy, business bankruptcy, municipal bankruptcy — as well as bankruptcy jurisdiction, procedure, and administration.

However, in the case of consumer bankruptcy reform, the Commissioners were generally not in agreement.⁹

Chapter 7. Consumer debtors usually avail themselves of one of two operative chapters of the U.S. Bankruptcy Code.¹⁰ Chapter 7 of the Code governs liquidation of the debtor's estate and is often referred to as "straight bankruptcy." Under the supervision of a standing trustee, the debtor's assets are liquidated, *i.e.*, reduced to cash, and the proceeds are distributed to creditors in accordance with the procedures mandated. At the conclusion, the debtor receives a "discharge," which operates as a permanent injunction against any attempt by a creditor to collect discharged debts.

Chapter 13. Chapter 13 has a jurisdictional threshold for filing. It is limited to an individual (and spouse) with regular income whose aggregate unsecured and secured debts are less than \$250,000 and \$750,000 respectively. 11 U.S.C. § 109.

⁵ The Bankruptcy Reform Act of 1978, P.L. 95-598, 92 Stat. 2549 (November 6, 1978).

⁶ 30 Stat. 544 (July 1, 1898).

⁷ Report of the Commission on Bankruptcy Laws, H.R. Doc. No. 137, Parts I and II, 93rd Cong., 1st Sess. (1973).

⁸ "Bankruptcy: The Next Twenty Years," National Bankruptcy Review Commission Final Report (Government Printing Office, October 20, 1997). The report is accessible on the Internet: <<http://www.access.gpo.gov/NBRC>>.

⁹ See, "Recommendations for Reform of Consumer Bankruptcy Law by Four Dissenting Commissioners," *id.*

¹⁰ For a more detailed explanation of bankruptcy procedure, see CRS Rep. 97-1057A, "A Bankruptcy Primer: Liquidation and Reorganization Under the U.S. Bankruptcy Code," by Robin Jeweler.

Chapter 13 contemplates a more expedited and streamlined procedure for individual (*i.e.*, consumer) reorganization than that provided for under chapter 11, which is designed to accommodate business reorganization.¹¹ In contrast to chapter 11, a chapter 13 reorganization always requires the participation of a standing trustee. It does not establish creditor committees, nor do creditors vote to accept or reject a plan of reorganization, although they are given the opportunity to accept certain provisions and interpose objections. Only the debtor may propose the reorganization plan, which must be completed within a specified three to five year time frame. A debtor receives a discharge of indebtedness not upon confirmation, but upon completion of all payments under the plan.

Plans are generally required to be completed within three years of the first payment under the reorganization plan, unless the debtor requests and the court approves a modification to extend it for up to, but no longer than five years. 11 U.S.C. § 1329.

Distinctive features of the U.S. Bankruptcy Code.

Many features of bankruptcy administration under the modern Code lead to disparities in the financial outcome of debtors who undergo reorganization. However, many of these statutory features have considered, deliberate policy and political explanations for their genesis. We examine several which are relevant to consumer bankruptcy filings.

The function of exclusions and exemptions in bankruptcy. The U.S. Bankruptcy Code, by design, is *not* an equalizer of wealth among all bankruptcy debtors. Each bankruptcy is highly fact specific; but as a general proposition, a debtor who enters bankruptcy with more wealth is likely to emerge from bankruptcy with more assets intact. Any disparity in the outcome among consumer bankruptcy debtors is, in large part, a function of the bankruptcy system of exclusions and exemptions.

A legal treatise observes that “[few people would voluntarily take any legal action which meant the surrender of so much of their possessions as to leave them destitute and virtually helpless.”¹² Hence, when an individual debtor’s assets are liquidated, the law permits him or her to retain a certain minimum of money and property necessary to realize a “fresh start.” When a debtor files in bankruptcy, a bankruptcy “estate” is created. In some cases, the law permits the debtor to *exclude* property from the estate altogether; in others, property is included in the estate, but is *exempted* from the reach of creditors.

¹¹ Although chapter 11 is clearly designed to facilitate business, *i.e.*, corporate reorganization, an individual consumer debtor not engaged in business is permitted to file. *Toibb v. Radloff*, 501 U.S. 157 (1991). The 1994 Bankruptcy Reform Act amendments significantly raised the permissible debt levels for filing under chapter 13. Hence, many individuals who could not file under chapter 13 and of necessity filed to reorganize under chapter 11, may now avail themselves of chapter 13.

¹² 2 Cowans Bankr. Law and Practice § 8.1 (6th Ed. 1994).

Although it would be within Congress' authority to establish a uniform set of bankruptcy exemptions which would be binding upon the states by virtue of the Supremacy Clause, the Code does not do so.¹³ Despite recommendations from the 1970 Bankruptcy Commission advising Congress to adopt a uniform system of national bankruptcy exemptions,¹⁴ Congress declined to do so. Congress permits not just that the debtor make an election between federal and state created exemptions, but permits the states to deny debtors the use of — or “opt out” from — federal exemptions.¹⁵ Consequently, even though there is a significant variance between the states in the generosity of their exemptions, more than half have enacted laws that deny debtors the use of federal exemptions.¹⁶

When the debtor's state of domicile has *not* enacted legislation which precludes a debtor from electing federal exemptions, the following are available:¹⁷

- the debtor's aggregate interest, not to exceed \$15,000, in real or personal property that the debtor uses as a residence, or in a burial plot for the debtor or a dependent;
- the debtor's interest, not to exceed \$2,400, in a motor vehicle;
- the debtor's interest, not to exceed \$400, in any one item or \$8,000 in aggregate value, in household furnishings, household goods, wearing apparel, appliances, books, animals, crops, or musical instruments, that are held for personal or family use of the debtor;
- the debtor's aggregate interest, not to exceed \$1000, in jewelry held primarily for the personal use of the debtor;
- the debtor's aggregate interest in any property, not to exceed \$800, plus up to \$7,500 of any unused amount of the exemption for housing above;
- the debtor's aggregate interest, not to exceed \$1,500, in any implement, professional books, or tools of the trade of the debtor;

¹³ The U.S. Constitution expressly delegates to the Congress the power “To establish ... uniform Laws on the subject of Bankruptcies throughout the United States.” Article I, section 8, clause 4.

¹⁴ Report of the Commission on Bankruptcy Laws, H.R. Doc. No. 137, Part I, 93rd Congress, 1st Session 170-173 (1973).

¹⁵ The opt-out program for exemptions was one of many compromises between the Senate, which advocated retaining exemptions under state law, and the House, which enacted a bill premised on federal exemptions. See, Kenneth N. Klee, Legislative History of the Bankruptcy Reform Act of 1978, in Annual Survey of Bankruptcy Law 21 (Callaghan & Co. 1979).

¹⁶ 2 Cowans, *supra* at § 8.2.

¹⁷ Pursuant to amendments effected by the 1994 Reform Act, monetary amounts for exemptions will be adjusted automatically at three-year intervals to reflect the change in the Consumer Price Index. 11 U.S.C. § 104(b).

- any unmaturred life insurance contract owned by the debtor;
- the debtor's aggregate interest, not to exceed \$8,000, in any accrued dividend under, or loan value of, any unmaturred life insurance contract under which the insured is the debtor;
- professionally prescribed health aids;
- the debtor's right to receive social security benefits, unemployment compensation, public assistance benefits, veterans' benefits, disability, illness or unemployment benefits, alimony and support to the extent reasonably necessary;
- benefits under certain pension, profit sharing, stock bonuses, annuity or similar plan or contract, to the extent necessary for the support of the debtor;
- the debtor's right to receive property traceable to an award under a crime victim's reparation law; a payment on account of a wrongful death of an individual of whom the debtor was a dependent, to the extent reasonably necessary for the support of the debtor; a personal injury award not exceeding \$15,000 for actual compensation (not including pain and suffering); and, payment in compensation for loss of future earnings, to the extent reasonably necessary for support.

In states where federal elections are not permitted, the debtor is limited to his exemptions under applicable state law and nonbankruptcy federal statutes. The amount and value of state law exemptions varies enormously. Among the best-known are those states with homestead exemptions of unlimited monetary value.¹⁸ Media attention is frequently given to wealthy debtors who establish prebankruptcy residency in a state with a generous homestead exemption.¹⁹ Thus, when Bowie Kuhn and Harvey Meyerson established homesteads in Florida for \$1 million and \$1.75 million respectively, observers pointed to the ease with which debtors abuse the bankruptcy laws. But these anecdotal illustrations of "abuse" are the result of a deliberate congressional decision to permit states to limit their residents to state law exemptions, and of the deliberate statutory policy of various states to permit, for whatever reason, residents to avail themselves of an unlimited homestead exemption.

Another area which leads to great disparity in the treatment of consumer debtors is the disposition of pension funds. In some instances, a debtor's pension funds may

¹⁸ Homestead exemptions in Florida, Iowa, Kansas, South Dakota, and Texas are of unlimited monetary value.

¹⁹ See, e.g., Tim Nickens, *Limiting Debtor Luxury*, THE HERALD, March 30, 1994 at 3A features five individuals who relocated to Florida to purchase homes in excess of one million dollars to benefit from the state homestead exemption prior to filing in bankruptcy: Bowie Kuhn, Harvey Meyerson, Paul Bilzerian, Marvin Warner, and Martin Siegel. See also, Kirstin Downey, *Antonelli's Lifestyle Survives Bankruptcy*, THE WASHINGTON POST, December 14, 1991 at A1.

be completely excluded from the bankruptcy estate;²⁰ in others, they may be exemptible under either the Code's exemptions²¹ or state law. The net result of the complex interaction of these laws is that a debtor's pension assets — often substantial — may be *excluded*, or some or all of the pensions funds may be *exempted*, from the bankruptcy estate available to satisfy creditor claims. When assets are excluded from the estate, they are not administered by the bankruptcy court. When they are exempted, they are beyond creditors' reach. Thus, the fact that debtors emerge from bankruptcy with various amounts of assets intact, though often perceived to be an "abuse" of the law, is often a result of the law's application.

Voluntary vs. mandatory reorganization. Although a debtor may be forced into chapters 7 or 11 involuntarily by creditors,²² that is rarely the case. The vast majority of all bankruptcy cases are filed voluntarily by the debtor. Chapter 13 may *only* be entered voluntarily by the debtor.

Chapter 13 was expressly designed to have built-in incentives to encourage debtor filing as an alternative to liquidation under chapter 7. Among those features are the "superdischarge", *i.e.*, the possibility of paying down and ultimately discharging some types of debt that may not be discharged under chapter 7, and the ability to save the debtor's home by permitting him to cure arrearages in a home mortgage where defaults may have occurred and foreclosure proceedings commenced.

Creditors are benefitted by the "best interests of the creditor" confirmation standard, *i.e.*, the requirement that creditors receive more under the debtor's proposed reorganization plan than they would if the debtor were liquidated under chapter 7. Indeed, creditors generally receive greater repayment when the debtor pledges post-petition income to debt repayment, than is the case under chapter 7 where only pre-petition assets are dedicated to pre-petition debt satisfaction. That is why creditors have long sought "mandatory" consumer reorganization.

The "fresh start" policy implicit in bankruptcy law. Chapter XIII wage earner reorganization was formally introduced into the Bankruptcy Act of 1898 by 1938 amendments effected by the Chandler Act.²³ In 1934, however, the U.S. Supreme Court, in *Local Loan Co. v. Hunt*,²⁴ had occasion to consider the question whether a bankruptcy debtor's assignment of (future) wages under state law created a lien that was nondischargeable under the federal bankruptcy law. Creditors argued that their claim for future wages created a security interest — a statutory lien — that could not be discharged in bankruptcy. The Court held that an assignment of future wages did *not* create a nondischargeable lien in bankruptcy:

²⁰ 11 U.S.C. § 541(c)(2). See also, *Patterson v. Shumate*, 504 U.S. 753 (1992).

²¹ 11 U.S.C. § 522(d)(10)(E).

²² 11 U.S.C. § 303.

²³ 52 Stat. 840 (June 22, 1938).

²⁴ 292 U.S. 234 (1934)

One of the primary purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.’ ...

When a person assigns future wages, he, in effect, pledges his future earning power. The power of the individual to earn a living for himself and those dependent upon him is in the nature of a personal liberty quite as much if not more than it is a property right. To preserve its free exercise is of the utmost importance, not only because it is a fundamental private necessity, but because it is a matter of great public concern. From the viewpoint of the wage-earner there is little difference between not earning at all and earning wholly for a creditor. Pauperism may be the necessary result of either. The amount of the indebtedness, or the proportion of wages assigned, may here be small, but the principle, once established, will equally apply where both are very great. The new opportunity in life and the clear field for future effort, which it is the purpose of the Bankruptcy Act to afford the emancipated debtor, would be of little value to the wage-earner if he were obliged to face the necessity of devoting the whole or a considerable portion of his earnings for an indefinite time in the future to the payment of indebtedness incurred prior to his bankruptcy. Confining our determination to the case in hand, and leaving prospective liens upon other forms of acquisitions to be dealt with as they may arise, we reject the Illinois decisions as to the effect of an assignment of wages earned after bankruptcy as being destructive of the purpose and spirit of the Bankruptcy Act.²⁵

Both the 1970 and the 1994 Bankruptcy Commissions considered and rejected the notion of requiring consumer debtors to devote future income to debt satisfaction as a condition of obtaining relief in bankruptcy.

1973 Report of the Commission on Bankruptcy Laws. The Commission which helped lay the foundation for the current Code considered proposals for limiting the bankruptcy relief available to wage earners. The Commission noted that the frequency of utilization of wage earner reorganization, chapter XIII under the Bankruptcy Act of 1898, reflected local legal “culture,” that is, the familiarity of the local bar with and the propensity of attorneys to encourage debtors to file under chapter XIII.²⁶ In some districts, debtors were advised by attorneys more knowledgeable in implementing reorganization as to its viability, and were encouraged by the court and creditors to reorganize; in others, wage earner reorganization was an unfamiliar, and therefore, nonpreferred procedure.

Nonetheless, the Commission specifically considered and rejected the notion of *requiring* wage earner reorganization:

In communities where Chapter XIII is used extensively, the Commission is informed that referees are not only hospitable, but counsel and the credit community generally encourage, if indeed they do not insist, that wage-earner debtors in financial distress petition for relief under Chapter XIII. ...In any event,

²⁵ Id., 244. Citations omitted.

²⁶ Report of the Commission on Bankruptcy Laws, *supra* at 157.

proposals have been made to Congress from time to time that a debtor able to obtain relief under Chapter XIII should be denied relief in straight bankruptcy, and the Commission has received communications expressing support for a change in the Bankruptcy Act to this effect.

After Congressional hearings in 1967, however, the House Judiciary Committee determined that it should not recommend the enactment of this proposed change in the provisions of the Bankruptcy Act applicable to wage earners. The proposal was opposed by the Judicial Conference of the United States, the National Bankruptcy Conference, the Association of the Bar of the City of New York, and spokesmen for labor unions. The measure was supported by the American Bar Association, the American Bankers Association, the Chamber of Commerce of the United States, CUNA International, Inc. the National Federation of Independent Business, and the American Industrial Bankers Association.

The arguments against the proposal included objections made to the difficulties of achieving any nationally uniform standard of application by referees throughout the country, as evidenced by the divergence of their viewpoints regarding the virtues of Chapter XIII. Another view expressed by opponents was that fulfillment of a debtor's commitment made pursuant to a Chapter XIII plan requires not merely a debtor's consent but a positive determination by him and his family to live within the constraints imposed by the plan during its entire term and a will to persevere with the plan to the end. Imposition of a Chapter XIII plan on an unwilling debtor, it was said, would be almost bound to encourage the debtor to change employment and, if necessary, to move to another area to escape the importuning calls and correspondence of his creditors. Likewise, those petitioning debtors turned away by the court on the ground that they failed to show that relief would not be obtainable under Chapter XIII would be motivated to change jobs and locations to get away from creditors who would threaten garnishment and other means of collecting debts. In states where wage garnishment is an unavailable remedy of creditors, the impact of the proposed legislation would have been minimal. A final argument made in opposition to the proposed legislation was that business debtors are not subject to any limitation on the availability of straight bankruptcy relief, including discharge from debts, and it was pointed out that, quite apart from bankruptcy, business debtors are able to incorporate and to limit their liability to their investments in corporate assets. To force unwilling wage earners to devote their future earnings to payment of past debts smacked to some of debt peonage, particularly when business debtors could not be subjected to the same kind of regimen under the Bankruptcy Act.

The Commission has considered the arguments made for conditioning the availability of bankruptcy relief, including discharge, on a showing by the debtor that he cannot obtain adequate relief from his condition of financial distress by proposing a plan for payment of his debts out of his future earnings. The Commission has concluded that forced participation by a debtor in a plan requiring contributions out of future income has so little prospect for success that it should not be adopted as a feature of the bankruptcy system.²⁷

²⁷ Id. at 158-159. Footnotes omitted. Cited with approval by the House Judiciary Committee in the legislative history of the 1978 Bankruptcy Reform Act. H.R. Rep. 595, 95th Congress, 1st Session 120-121 (1977).

Arguably, the Commission's concerns about national uniform standards for implementation of reorganization are outdated. However, its concerns with respect to debtor commitment in a mandatory reorganization, the result of debtor insolvency absent reorganization, and of a perceived inequity between consumer and business debtors, remain relevant.

1997 Report of the National Bankruptcy Review Commission. Twenty years of experience with the U.S. Bankruptcy Code did not lead the NBRC to significantly alter the judgement expressed in the 1973 Commission Report. The NBRC considered proposals from the credit industry advocating some sort of debtor-by-debtor scrutiny before permitting debtors to file for chapter 7.²⁸ The NBRC, by a 5-4 vote, reaffirmed maintenance of the status quo:²⁹

Some witnesses concluded that using a means test to establish Chapter 7 eligibility would fall hardest on families already financially pressed past the breaking point, with little provable benefit. Others expressed their concern that with a completion rate of only 32% for *voluntary* Chapter 13 plans today, forcing unwilling debtors into Chapter 13 would only burden the system, decreasing both the overall repayment to creditors and the successful rehabilitation of debtors. ...In a time of increasing strain on judicial resources, questions also have arisen about the number of judges, clerks, and other staff needed to administer a means test to hundreds of thousands of debtors annually. The credit industry has sought means testing consistently for at least 30 years, but Congress has consistently refused to change the basic structure of the consumer bankruptcy laws.

There is no dispute on one point: bankruptcy should be used only by the needy and not by others. The bankruptcy laws should *never* invite abuse. When Congress charged the Commission with its duties, it cautioned that there was no evidence that the bankruptcy system needed radical reform. It characterized the system as 'generally satisfactory,' and directed the Commission to review, improve and update the Code 'in ways which do not disturb the fundamental tenets and balance of current law.' The Commission conducted an intensive review of consumer bankruptcy that resulted in a full set of recommendations, but the proposals contemplate no change in the basic structure of consumer bankruptcy. Access to Chapter 7 and to Chapter 13, the central feature of the consumer bankruptcy system for nearly 60 years, should be preserved.³⁰

In summary, the two Bankruptcy Commissions charged with considering the prospect of mandatory consumer reorganization cited the following reasons in support of their rejection of the concept:

²⁸ NBRC Final Report, *supra* at 89. ("The consumer bankruptcy debates never lacked a discussion of whether debtors are receiving 'more relief than they need,' although the cost and implementation of a 'means testing' system were not developed in specific detail. These features are now detailed in the 'means test' legislation recently proposed in H.R. 2500.")

²⁹ None of the four dissenting commissioners appears to specifically advocate "means testing" as a consumer bankruptcy reform. They do, however, "disagree most strongly with the [Commission] Framework proposals that . . .discourage Chapter 13 repayment plans and encourage Chapter 7 liquidations[.]" Dissent, *supra* at 3.

³⁰ *Id.* at 90-91. Footnotes omitted; emphasis in original.

- difficulty of compliance by unwilling/unable debtors. Subjecting those, for whatever reasons, least able to manage finances to an extremely strict long-term future budget is likely to fail;
- current low success rate for voluntary reorganization;
- difficulty of creditor collection where debtors avoid bankruptcy relief to evade mandatory reorganization;
- no comparable business requirement;
- increased implementation costs.

Congress has also considered and rejected the idea.³¹

Overview of “needs based” consumer reorganization legislation.

S. 1301 is designed to “stem the tide of casual bankruptcies” by addressing the explosion in consumer filings.³²

By far the most pressing bankruptcy policy question facing America today relates to the explosion of consumer bankruptcies. Last April, I chaired a hearing on the crisis in consumer bankruptcies. While there’s not much agreement about the root causes of the rise in consumer bankruptcies, it’s obvious that Congress needs to do something now — before the economy takes a downturn — to reverse this trend....

....

The Consumer Bankruptcy Reform Act will discourage casual bankruptcies by sending a clear signal that you can’t file for bankruptcy and walk away from your debts if you have the ability to re-pay some portion of those debts. This is a simple and straightforward idea whose time has come. According to my research, Congress considered reserving bankruptcy relief for only those Americans who can’t re-pay their debt as far back as 1932. So, what we’re proposing is not based on some unprecedented concept, but instead has a long and distinguished history.³³

³¹ See, e.g., *Oversight Hearing on Personal Bankruptcy Before the House Judiciary Subcomm. on Monopolies and Commercial Law*, 97th Congress, 2d Session (1982); “*Bankruptcy Reform Act of 1978 (Future Earnings), Part 2*,” *Hearings Before the Senate Judiciary Subcomm. on Courts*, 97th Congress, 1st Session (1981); *Hearing on H.R. 1057 and H.R. 5771 Before Subcomm. No. 4 of the House Comm. on the Judiciary*, 90th Congress, 1st Session (1967).

³² 143 CONG. REC. S10884 (daily ed. October 21, 1997) (Statement of Sen. Grassley).

³³ *Id.* at S10884-85.

The needs based components of proposals in legislation currently before the 105th Congress are examined below.³⁴

H.R. 3150, 105th Congress, 2nd Session (1998), the “Bankruptcy Reform Act of 1998.” This bill, though far broader in scope, incorporates the essential “means testing” of H.R. 2500.³⁵ If enacted, it would effect “means testing” by requiring debtors who seek to file under chapter 7 to satisfy complicated financial formulas intended to weigh the debtor’s debt against his income. If a debtor is ineligible to file under chapter 7, he would be required either to file under chapter 13, or to refrain from filing. This is the basic principle behind “needs based” bankruptcy, *i.e.*, only those who meet criteria establishing “need” to file under chapter 7 will be permitted to do so.

“Needs based” bankruptcy. The bill would amend that section of the U.S. Bankruptcy Code, 11 U.S.C. § 109, which defines who may be a debtor under the various chapters, by providing that a debtor (which includes an individual and spouse) may *not* file under chapter 7 if the debtor has “income available to pay creditors as determined under” the new statutory standards.

“Income available to pay creditors” means (1) a current monthly income of 75 percent of the national median family income for a family of equal size; (2) projected monthly net income greater than \$50; and, (3) projected monthly net income sufficient to repay 20 percent or more of unsecured non-priority claims³⁶ during a five-year, as opposed to the currently presumptive three year, repayment plan.³⁷ The terms are further defined as specified below.³⁸

³⁴ The discussion herein is intended to provide a conceptual overview rather than a technical analysis of the proposed legislation.

³⁵ This report surveys Title I of H.R. 3150 addressing consumer bankruptcy provisions; Titles II through VI address other areas of bankruptcy reform.

³⁶ See 11 U.S.C. § 507 which classifies priority claims.

³⁷ H.R. 3150, § 101(4) would add a new subsection 11 U.S.C. § 109(h) to the Code.

³⁸ New subsection 109(h) would further provide that:

(2) Projected monthly net income shall be sufficient [to repay 20 percent of unsecured nonpriority claims] ... if, when multiplied by 60 months, it equals or exceeds 20 percent of the total amount scheduled as payable to unsecured nonpriority creditors.

(3) ‘Projected monthly net income’ means current monthly total income less—

(A) the expense allowances under the applicable National Standards, Local Standards and Other Necessary Expenses allowance (excluding payments for debts) for the debtor, the debtor’s dependents, and, in a joint case, the debtor’s spouse if not otherwise a dependent, in the area in which the debtor resides as determined under the Internal Revenue Service financial analysis for expenses in effect as of the date of the order for relief;

(B) the average monthly payment on account of secured creditors, which shall be calculated as the total of all amounts scheduled as contractually payable to secured creditors in each month of the 60 months following the date of

(continued...)

“Adequate income” and “extraordinary circumstances”. The bill requires a chapter 13 debtor to commit adequate income to a reorganization plan that pays unsecured creditors. In essence, this means that during the course of the five year reorganization,³⁹ if the trustee or an unsecured creditor objects to the debtor’s proposed reorganization plan, then “the total amount of monthly net income received by the debtor shall be paid to unsecured nonpriority creditors under the plan[.]”⁴⁰

One of the major distinctions between current law and the proposed bill is the application of economic and statistical formulae to determine such basic factors as who may file under chapter 7 versus 13, and what will be deemed “disposable income.”

Currently, the formulation of the reorganization plan provides far more discretion and leeway to a debtor — though the plan is always subject to scrutiny by a trustee and the court to protect unsecured creditors. Further, under current law, when an unsecured debtor objects to a proposed reorganization, the debtor may be required to provide all of his projected disposable income for a three year period to payment under the plan. However, there is greater flexibility in the present definition of “disposable income,” which means “income which is received by the debtor and

³⁸(...continued)

the petition by the debtor, or, in a joint case, by the debtor and the debtor’s spouse combined, and dividing that total by 60 months; and

(C) the average monthly payment on account of priority creditors, which shall be calculated as the total amount of debts entitled to priority, reasonably estimated by the debtor as of the date of the petition, and dividing that total by 60 months.

³⁹ The presumptive term of a chapter 13 plan for a debtor whose income equals 75 percent of the national median income would be five years, unless the court approves a seven year plan “for cause;” if the debtor’s income is less than 75 percent of national median income, the repayment period would be three years, with an extension to five years “for cause.” See, § 410 of H.R. 3150.

⁴⁰ H.R. 3150, § 102(1). Disposable, that is, “monthly net income” is defined as:

... the amount determined by taking the current monthly total income of the debtor less — (A) the expense allowances under the applicable National Standards, Local Standards and Other Necessary Expenses allowance (excluding payments for debts) for the debtor, the debtor’s dependents, and, in a joint case, the debtor’s spouse if not otherwise a dependent, in the area in which the debtor resides as determined under the Internal Revenue Service financial analysis for expenses in effect as of the date it is being determined; (B) the average monthly payment on account of secured creditors, which shall be calculated as of the date of the determination as the total of all amounts then remaining to be paid on account of secured claims pursuant to the plan less any of such amounts to be paid from sources other than the debtor’s income, divided by the total months remaining of the plan; and (C) the average monthly payment on account of priority creditors, which shall be calculated as the total of all amounts then remaining to be paid on account of priority claims pursuant to the plan less any of such amounts to be paid from sources other than the debtor’s income, divided by the total months remaining of the plan.

which is not reasonably necessary to be expended ... for the maintenance or support of the debtor or a dependent of the debtor.”⁴¹ The court and the trustee, not creditors, however, are the primary overseers of the debtor’s proposed expenses.

The bill contemplates an intensive five to seven-year program of debt repayment overseen by the bankruptcy court — the debtor will make payments of “projected monthly net income” according to externally derived payment criteria, and will be required to pass on any additional income to unsecured creditors over the course of the five years. The trustee will be required to investigate and verify the debtor’s projected monthly net income over the course of the plan’s duration, and file annual reports with the court (with copies to creditors.)

The debtor will be permitted to modify the plan annually to allow additional expenses if “extraordinary circumstances” so warrant. “Extraordinary circumstances” are not defined in the bill. So the matter may be subject to litigation as parties with sufficient resources seek to clarify what the term encompasses.⁴² Parties who cannot afford to litigate such matters with their creditors, as can be expected of many bankruptcy debtors, may be subject to a variety of pressures to reaffirm debt or seek a dismissal or conversion.⁴³ To the extent that the debtor forfeits any right to disposable income for a period of five years, it may be difficult to negotiate unforeseen expenses.

The actual process for establishing extraordinary circumstances and modifying the plan is arguably cumbersome. Basically, the debtor files a report with the court which explains and itemizes income which has been lost in the preceding six months, and itemizes replacement income which has been secured or is *expected*; itemizes each additional expense; gives a detailed description of why the debtor requires the additional expense; and, provides a sworn statement by the debtor and his attorney verifying the information.

⁴¹ 11 U.S.C. § 1325(b)(2). See, *In re Presley*, 201 B.R. 570 (Bankr.N.D.Fla. 1996) (Under the disposable income test for chapter 13 confirmation, courts must determine on a case-by-case basis, whether debtor’s listed monthly expenditures, individually and as a whole, are reasonably necessary for maintenance or support of the debtor.)

⁴² For example, would orthodontics for a debtor’s children be considered an “extraordinary circumstance”? Would the debtor have to litigate the question of whether braces served a structural rather than cosmetic purpose? Tutoring for a child’s learning disability? Replacement of household appliances, or an automobile? Currently, expenses which are “reasonably necessary for maintenance and support” are subject to the court’s review, but the term “extraordinary” presumably will establish a far stricter standard.

⁴³ The legislative history to the 1978 Code demonstrates many instances of concern about disparities between debtors and creditors with respect to access to resources to fund litigation. Writing about an exception to discharge, the House Judiciary Committee wrote, “The threat of litigation over this exception to discharge [11 U.S.C. § 523(a)(2)] and its attendant costs are often enough to induce the debtor to settle for a reduced sum, in order to avoid the costs of litigation. Thus, creditors with marginal cases are usually able to have at least part of their claim excepted from discharge (or reaffirmed), even though the merits of the case are weak.” H.R. Rep. 95-595 at 130.

A debtor will have one window of opportunity to modify the plan within 45 days before each anniversary of confirmation.⁴⁴ In order to do so, the debtor must file a statement of “extraordinary circumstances” with the court and the trustee. The bill is silent on adjustments that may require attention outside of the anniversary of confirmation. If neither the trustee nor creditors object, the debtor’s statement of necessary modification may take effect. If objections are interposed, there will be a hearing before the court to rule on the proposed modification. The debtor will have the legal burden of proving “extraordinary circumstances.” The court may award a reasonable attorney’s fee to the prevailing party if the nonprevailing party was “not substantially justified.” Further, the debtor must state, “under penalties of perjury,” the “amount of monthly net income, which may be as adjusted under section 111 ... and the amount of monthly net income which will be paid per month to unsecured non-priority creditors under the plan.”⁴⁵

The bill would also expand the debtor’s duty to file specified information with the bankruptcy court.⁴⁶ Filing documentation would include three years of prior tax returns; copies of all payment advices received within 60 days of filing; a statement of the amount of projected monthly net income, itemized to show how calculated; and, statements disclosing any “reasonably anticipated” increase in income or expenditures for the next 12 months. Failure to file all the information required would result in a mandatory, automatic case dismissal without the need for a court order.⁴⁷

Adequate protection for consumers. Under current law, a bankruptcy court clerk is obligated to provide a consumer debtor written notice which indicates each chapter under which the individual may proceed.⁴⁸

H.R. 3150 would direct the Executive Office for the United States Trustees (EOUST) to develop a financial management training curriculum to educate individual debtors on how to better manage their finances.⁴⁹ The program would be implemented in three judicial districts on a pilot basis. Subsequently, the EOUST would evaluate the effectiveness of the program compared to those carried out by the credit industry, by standing trustees, and by consumer counselling groups.

Detailed, substantive disclosure statements for a “debt relief counselling agency” are established.⁵⁰ Further, a new section of the Code, 11 U.S.C. § 527 entitled “Debtor’s bill of rights” would prescribe detailed requirements for advertising by debt

⁴⁴ New § 111(b), added by § 102 of H.R. 3150.

⁴⁵ The legal implications of subjecting debtors to prosecution for perjury based upon a “reasonable” anticipation or expectation of *future* income and payout is not considered in this report.

⁴⁶ H.R. 3150, § 407.

⁴⁷ *Id.*, § 408.

⁴⁸ 11 U.S.C. § 342(b).

⁴⁹ H.R. 3150, § 112.

⁵⁰ *Id.* §114 requires that specific information about bankruptcy and the role of attorneys, bankruptcy petition preparers and debt relief counselling agencies.

relief counselling agencies and proscribed practices.⁵¹ Enforcement mechanisms are also established.

Adequate protection for secured lenders. Subtitle C of H.R. 3150 would amend many provisions of the Code to enhance the position of secured creditors throughout the course of the bankruptcy proceedings. These include:

- ***Discouraging bad faith repeat filings; stopping abusive conversions from chapter 13.***⁵² The bill would amend the automatic stay provision of the Code, 11 U.S.C. § 362, to provide that the stay may or may not apply with respect to specific creditors if a debtor had a previous case pending within the previous year. The court will have to determine whether previous cases were filed in “good faith”; whether the previous case was dismissed by the court “without substantial excuse (but mere inadvertence or negligence shall not be substantial excuse unless the dismissal was caused by the negligence of the debtor’s attorney);” and, whether there has been a substantial change in the financial or personal affairs of the debtor since the previous dismissal. In certain instances, the court would be permitted to grant an *in rem* order in connection with the stay.⁵³ When a debtor converts from chapter 13 to another chapter (presumably 7), secured creditors would be entitled to their nonbankruptcy claim amount, not an amount reduced by a court valuation or determination made in connection with allowing a secured claim.⁵⁴
- ***Definition of “household goods”.***⁵⁵ The bill would amend the Code to provide a uniform definition of “household goods” patterned after the Federal Trade Commission’s Credit Practices Rules.⁵⁶ This amendment is intended to end litigation over what items qualify for the federal exemption for household goods. To the extent that the proposed definition of household goods is somewhat narrower than some courts have interpreted it to be, it will work a hardship on the debtor having to avail himself of the exemption. For example, the new definition specifies that “household goods” *excludes* “electronic entertainment equipment other than one television and one radio.” Some would argue that used consumer televisions, tape players, nintendo players, etc. are irreplaceable to a debtor but of minimal resale value, hence of negligible value to the creditors on whose behalf they would be seized. Some have also argued that a narrow definition of household goods benefits home finance companies who routinely take blanket liens on a customer’s personalty to secure loans; debtors would be under increased pressure to reaffirm otherwise dischargeable debts in order to retain more of their household chattels.

⁵¹ Id., §115,

⁵² Id., § 116.

⁵³ Cf., Recommendation of the NBRC, 1.5.6 *In Rem Orders*, supra note 8 at 8.

⁵⁴ H.R. 3150, §127

⁵⁵ Id., §122

⁵⁶ 16 C.F.R. § 444.1(i) (1997).

- *Debtor retention of secured property; relief from the automatic stay.*⁵⁷ There is a split among the courts regarding the effect of a debtor's failure to reaffirm a debt when the debtor retains the collateral and stays current on all payments.⁵⁸ The debtor's retention of the property without a reaffirmation while maintaining payment is referred to as a "ride-through." The bill would amend the Code to clarify that a debtor is required to formally reaffirm a debt or redeem the collateral in compliance with Code requirements. Failure by the debtor to do so would result in a creditor being permitted to pursue the collateral outside of bankruptcy. Comparable provisions with respect to the assumption of an unexpired lease of the debtor would apply. In the case the certain individual filings, a request for relief from the automatic will be self-executing after 60 days unless the court issues a final decision before then, or finds compelling circumstances warranting an extension of time.
- *Restraining abusive purchases on secured credit; fair valuation of collateral.* 11 U.S.C. § 506 currently provides that a secured claim is secured up to the value of the collateral, and unsecured for any amount over the collateral's value. The bill would amend this section to provide that in individual bankruptcies under chapter 7, 11, 12, or 13, when a debtor purchases secured personal property within 6 months of filing bankruptcy, the amount of the secured claim must reflect the contract value of the claim (including unpaid interest and charges), not the market value of the collateral.⁵⁹ Valuation of consumer property claims under § 506 would be valued at "the price a retail merchant would charge for the property of that kind," overruling *Associates Commercial Corp. v. Rash*.⁶⁰

Adequate protections for unsecured lenders. Subtitle D of the bill would amend the Code to alter the relationship between high priority and nondischargeable debt, and makes several provisions to enhance the position of credit card lenders. These provisions include:

- *Debts incurred to pay nondischargeable debts.* The bill would amend the Code to make debts which are nondischargeable under § 523 high priority

⁵⁷ H.R. 3150, §§ 123, 124.

⁵⁸ Cases which have permitted ride-through include *Capital Communications Federal Credit Union v. Boodrow*, 126 F.3d 43 (2nd Cir. 1997), *cert. denied*, 118 S. Ct. 1055 (1998); *In re Belanger*, 962 F.2d 345 (4th Cir. 1992); *Lowry Federal Credit Union v. West*, 882 F.2d 1543 (10th Cir. 1989). *Contra*, *In re Johnson*, 89 F.3d 249 (5th Cir. 1996), *In re Taylor*, 3 F.3d 1512 (11th Cir. 1993); *In re Edwards*, 901 F.2d 1383 (7th Cir. 1990); *In re Bell*, 700 F.2d 1053 (6th Cir. 1983).

⁵⁹ H.R. 3150, § 128

⁶⁰ 117 S. Ct. 1879 (1997) (holding that under 11 U.S.C. § 506(a) the value of property retained by the debtor is "the cost the debtor would incur to obtain a like asset for the same proposed use" or the replacement value.)

unsecured claims as well.⁶¹ High priority unsecured claims, defined in § 507, get favored, *i.e.*, high priority, distribution from the debtor's bankruptcy estate. High priority claims, with the exception of child support and alimony, are not necessarily the same as nondischargeable claims. Nondischargeable claims may be pursued by a creditor against the debtor from assets received after he is out of bankruptcy. Entitling creditors of nondischargeable claims to high priority status as well will minimize the debtor's estate available for distribution to those creditors whose claims will be discharged, and permit holders of nondischargeable claims to collect from estate and nonestate assets.

- *Nondischargeability of credit card debt.*⁶² The bill would amend the Code to make credit card debt nondischargeable under chapters 7 and 13 when the debtor used a credit card "without a reasonable expectation or ability to repay." The use of a financial statement to obtain credit that is nondischargeable because the debtor made it "with an intent to deceive" will become nondischargeable if made by the debtor "without taking reasonable steps to ensure the accuracy of the statement." Debts are currently nondischargeable when incurred within 60 days before bankruptcy for the purchase of "luxury" goods aggregating more than \$1000; this category of nondischargeability would be broadened to cover "consumer debts" incurred within 90 days of bankruptcy.

Adequate protection for lessors. Subtitle E confers a variety of financial protections and enhancements to the position of a lessor of personal property to a debtor lessee in chapters 7 or 13. These benefits are generally in the nature of requiring a prompt assumption of a lease for personalty by the debtor; liberal relief from the automatic stay for creditors; and greater cash payments for use of the property during the reorganization.⁶³

Impact on the bankruptcy court system. A major effect of enactment of H.R. 3150 would be a substantial increase in the responsibilities of the judicial and administrative personnel of the U.S. bankruptcy courts. The oversight responsibilities for consumer bankruptcy administration are greatly increased. Also, information disclosure and collection requirements are broadened. Increased responsibilities include:

- the duty of the U.S. Trustee to educate consumer debtors prior to the commencement of a case about the purpose, benefits, and costs of proceeding under chapters 7, 11, 12, and 13 of the U.S. Bankruptcy Code; a description of services which may be available to the prospective debtor from an

⁶¹ H.R. 3150, §141. As the proposed language and the manner in which it operates is not clear, we assume this is the goal intended.

⁶² *Id.*, §§ 142 - 145.

⁶³ *Id.*, §§ 161 - 163

independent nonprofit debt counseling service; and, the name, address and telephone number of each local nonprofit debt counseling service.⁶⁴

- the trustee’s duty to annually investigate and verify the debtor’s past and projected monthly net income; and, the court’s responsibility to hold hearings and to rule on the legality of asserted “extraordinary circumstances” permitting an adjustment in monthly net income, etc., discussed *supra*.
- bankruptcy court clerks’ duty to compile detailed statistics regarding individual consumer debtors;⁶⁵ and
- the duty of the Attorney General to provide for a detailed, random audit of no less than one out of fifty consumer debtors. Aggregate information would be reported to the courts and to the public. The Attorney General would be authorized to contract with private auditors to satisfy this requirement.⁶⁶

S. 1301, 105th Congress, 1st Session (1997), the “Consumer Bankruptcy Reform Act of 1997”. S. 1301 takes a different approach to imposing needs based consumer bankruptcy standards. Rather than imposing national economic standards on all prospective consumer debtors, it would permit a more judicially labor-intensive determination of chapter 13 eligibility on a case-by-case basis.⁶⁷

A creditor initiated case-by-case approach to “needs based” bankruptcy. Section 707(b) of the U.S. Bankruptcy Code currently provides that a court, on its own motion or on a motion by the U.S. Trustee (but not at the request of a creditor), may dismiss a consumer bankruptcy case if granting relief would be a “substantial abuse” of chapter 7. There is a legal presumption *in favor* of the debtor’s request for relief.

The term “substantial abuse” is not defined in the Code. Hence, the courts, though bound by case law, have discretion to interpret the provision. Indeed, some courts have held that an ability to pay creditors sufficiently from future income standing alone warrants dismissal of a chapter 7 petition for substantial abuse.⁶⁸

⁶⁴ Id., § 111.

⁶⁵ Id., § 441.

⁶⁶ Id., § 404.

⁶⁷ 143 CONG. REC. S10885 (Statement of Sen. Grassley)(“[I]n order to forge a bipartisan compromise, the bill doesn’t make ability to repay the only factor in determining whether to transfer or dismiss a case. Instead, each debtor’s individual circumstances will be examined. In this way, our bill avoids the injustice which can accompany a crude formula with practically no exceptions.”)

⁶⁸ *Stuart v. Koch* (In re Koch), 109 F.3d 1285 (8th Cir. 1997); *Zolg v. Kelly* (In re Kelly), 841 F.2d 908 (9th Cir. 1988). See also, *Fonder v. United States*, 974 F.2d 996 (8th Cir. 1992)(In determining whether a debtor can fund a chapter 13 plan for purposes of dismissal of a chapter 7 case as substantial abuse, the essential inquiry is whether the debtor

Other courts have held that the fact that a debtor has income in excess of necessary expenses is not, by itself, sufficient to support a finding of substantial abuse of chapter 7. These courts are inclined to engage in a “totality of the circumstances” analysis in determining whether discharge would be a substantial abuse of chapter 7.⁶⁹

S. 1301, however, would amend § 707(b) to omit the current requirement that only the court or the U.S. Trustee may move for a dismissal on the grounds of “substantial abuse.” Other parties, including creditors, could move to have the debtor’s chapter 7 case dismissed *or, with the debtor’s consent, converted* to chapter 13. It would omit the presumption in favor of debtor relief. And, it would change the standard from “substantial abuse” by a debtor to mere “abuse,” with statutory guidance regarding what constitutes abuse. Reposing ultimate authority to bring an abuse allegation in the court and the U.S. Trustee, ensures, to some degree, that the allegation will not be prosecuted frivolously, or brought primarily as a strategic litigation tactic by adversarially-minded creditors who may have vast legal resources at their disposal.⁷⁰ Although the bill would provide attorneys’ fees to prevailing parties (discussed below), taking the decision away from more impartial judicial personnel and permitting creditors to initiate litigation may increase “abuse” litigation.

The following factors would be statutorily defined as criteria for a court to consider in determining whether proceeding in chapter 7 would constitute “abuse”:

- would the debtor’s income be sufficient to pay 20 percent or more of non-priority, unsecured claims if he filed under chapter 13;

⁶⁸(...continued)

has the ability to repay creditors with future income sufficiently to make a chapter 7 filing a substantial abuse; there is no requirement that a debtor be eligible for chapter 13 relief, and in some cases, despite a substantial abuse dismissal, the debtor may not qualify under chapter 13.)

⁶⁹ *Green v. Staples (In re Green)*, 934 F.2d 568 (4th Cir. 1991) (In determining whether a chapter 7 case should be dismissed on the ground that granting a discharge would be a substantial abuse, a totality of the circumstances analysis should be used, under which the bankruptcy court should consider whether the petition was filed because of sudden illness, calamity, disability, or unemployment; whether the debtor incurred cash advances and made consumer purchases far in excess of his ability to repay; whether the debtor’s proposed family budget is excessive or unreasonable; whether the debtor’s schedules and statement of current income and expenses reasonably and accurately reflect true financial condition; and whether the petition was filed in good faith, as well as in relation to the debtor’s future income and future necessary expenses.); *In re Krohn*, 886 F.2d 123 (6th Cir. 1989) (In determining whether to dismiss a chapter 7 case on the ground of substantial abuse, the court should ascertain from the totality of circumstances whether the debtor is really seeking advantage over creditors, or instead, is honest, in the sense that his relationship with creditors has been marked by essentially honorable and undeceptive dealings, and whether he is needy in the sense that his financial predicament warrants discharge of debts in exchange for liquidation of assets.)

⁷⁰ Currently, a U.S. Trustee may make a motion to dismiss a chapter 7 case for substantial abuse on the suggestion of a creditor. *U.S. Trustee for the Western District of Va. v. Clark (In re Clark)*, 927 F.2d 793 (4th Cir. 1991); *Stewart v. U.S. Trustee (In re Stewart)*, ___ B.R. ___, 1997 WL 757556 (10th Cir. BAP 1997).

- did the debtor file the petition in “bad faith”; and
- did the debtor make “good faith” efforts to negotiate an alternative repayment schedule or use alternative methods of dispute resolution prior to filing; did the creditor(s) unreasonably refuse the proposed negotiations.⁷¹

S. 1301, unlike H.R. 3150, would not remove the debtor’s initial discretion to determine whether it is appropriate to file under chapter 7 or 13. Creditors, however, would be permitted to intervene to seek dismissal or urge the debtor to convert to chapter 13.

Attorneys’ fees. The bill would amend the Code to award attorneys’ fees to prevailing parties in several instances. Civil penalties would be imposed on a debtor’s attorney in certain circumstances:

- if a trustee prevails on a motion to have a chapter 7 debtor’s case dismissed or converted, and if the debtor is represented by counsel, the court may order the debtor to reimburse the trustee for reasonable costs in prosecuting the motion, including reasonable attorneys’ fees.⁷²
- if the court does not grant a party in interest’s motion to dismiss or convert, the court may award the debtor reasonable attorneys’ fees and actual damages in an amount not less than \$5,000.
- Bankruptcy Rule 9011 currently requires debtor’s attorney to sign all filings. The signature represents that the attorney “has read the document; that to the best of the attorney’s ... knowledge, information, and belief formed after reasonable inquiry it is well grounded in fact and is warranted by existing law or a good faith argument... .” S. 1301 would amend the Code to stipulate that a court shall order assessment of civil penalties against an attorney who violates the rule. It would also add language to the Code which would require attorneys to perform “a reasonable investigation into the circumstances that gave rise to the [bankruptcy] petition” and to determine that it is well grounded in fact, warranted by law, and does not constitute an “abuse.” What responsibilities and standards are intended by this language are not clear. It may lessen the ability of bankruptcy attorneys to represent consumer debtors. Debtors, however, will be entitled to fees and damages if a party in interest brings a motion which the court finds was not substantially justified, or was brought solely for the purpose of coercing a debtor into waiving a right guaranteed in bankruptcy. This may lessen such litigation by creditors.
- Title II of S. 1301 is entitled “Enhanced Procedural Protections for Consumers.” It would permit the award of attorneys’ fees in many different procedural contexts: in connection with a contested claim under 11 U.S.C. § 502; in connection with a contested nondischargeable claim under 11 U.S.C.

⁷¹ S. 1301, § 102 amending 11 U.S.C. § 707.

⁷² Id.

§ 523; for violation of a discharge injunction or reaffirmation agreement requirement under 11 U.S.C. § 524; for a violation of the automatic stay, 11 U.S.C. § 362; for denial of a creditor's motion to deny a chapter 7 discharge (including punitive damages when the motion is not substantially justified) under 11 U.S.C. § 727.

Procedures to improve bankruptcy administration. Title III of S. 1301, entitled “Improved Procedures for Efficient Administration of the Bankruptcy System,” would implement many features similar to those in H.R. 3150. Examples include:

- *Consumer bankruptcy education.* Prior to the commencement of a consumer bankruptcy, the U.S. Trustee would provide the debtor a written notice advising him of the different bankruptcy chapters, and names and descriptions of independent nonprofit debt counseling services.
- *Debtor's duties.* The bill would amend 11 U.S.C. § 521 to require debtors to file more detailed financial information with the court, and permit creditors to obtain copies of that information. Information required would include copies of federal tax returns, a statement of projected monthly net income, itemized to show how calculated (but not subject to definitional criteria), and, a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of filing. Chapter 13 debtors would file a statement annually, subject to penalties of perjury, showing income and expenditures for the preceding tax year.⁷³
- *Mandatory dismissal.* If a debtor fails to file the documentation required, the case will automatically be dismissed on the 46th day after the petition is filed. The debtor may request a 20 day extension, if justified.⁷⁴
- *Improved consumer bankruptcy statistics.* Bankruptcy courts and the Administrative Office of the U.S. Courts would be directed to compile and report detailed information on assets, income and aggregate debt discharged by consumer debtors.⁷⁵
- *Audits.* The Attorney General would be directed to establish a method of randomly selecting not less than 1 out of 50 cases to be audited.⁷⁶

S. 1301 and H.R. 3150 are lengthy bills which have many features beyond needs based or mandatory chapter 13 consumer provisions. Provisions also address other

⁷³ S. 1301, § 301.

⁷⁴ Id., § 312.

⁷⁵ Id., § 306.

⁷⁶ Id., § 307

aspects of consumer bankruptcy reform. In many instances, provisions addressed are consistent with recommendations in the NBRC Report.⁷⁷

Implications of needs based bankruptcy.

As these bills, and others that may be introduced with the goal of effecting needs based bankruptcy work their way through the legislative process, congressional debate will likely focus on a wide range of issues and questions relating to the proper role of consumer bankruptcy in modern commercial life.

The NBRC, and others, have long identified the need to collect data to permit the development of a complete and accurate profile of those who need the relief afforded by bankruptcy, in addition to the avowed goals of enhancing accuracy and bankruptcy administration.⁷⁸ To the extent that the concepts embodied by needs based bankruptcy constitute a major shift in current bankruptcy practice, Congress may wish to revisit and reconsider many of the Code's basic philosophical underpinnings. A few aspects of this prospective debate are considered below.

A rigid, formulaic Bankruptcy Code. Despite its length and complexity, the U.S. Bankruptcy Code achieves, to some extent, an expeditious and streamlined procedure for dealing with consumer bankruptcy. A significant percentage of debtors who file under chapter 7 have little to no assets, and their cases are referred to as “no asset chapter 7's.”⁷⁹ Their cases can proceed with minimal professional involvement.

The proposed jurisdictional filing requirements in H.R. 3150 would likely necessitate that debtors obtain more individually tailored, sophisticated professional assistance — legal and financial — to determine what debtor filing options are. This would include preliminary calculations regarding the debtor's income in relationship to the national median income and the debtor's projected monthly net income in relationship to the percentage of unsecured debt.

Those debtors who are required to file under chapter 13 will experience five years of intensive judicial and professional financial review. Clearly, this new level of bankruptcy case management will involve higher costs. Whether those most in need of bankruptcy relief will be able to afford and receive the necessary assistance is an open question. Another unresolved issue is whether attorneys and financial service providers will be able to provide the services in a newly labor-intensive bankruptcy system. The challenge will be to provide services in a cost-effective manner that satisfies legal requirements but does not increase the public's perception that

⁷⁷ Among the recommendations with broad Commission support are those dealing with random audits of bankruptcy schedules; a national filing system; and, creditor rehabilitation programs to increase chapter 13 filings. NBRC Report, *supra* at 80.

⁷⁸ NBRC Report, Chapter 4: Data Compilation and Dissemination, *id.* at 919.

⁷⁹ “Chapter 7 cases account for nearly 70% of all bankruptcy filings. Approximately 95% of these chapter 7 cases are terminated as ‘no asset’ cases[.]” Ed Flynn, *Bankruptcy Statistical Update for 1996* in *The 1997 Bankruptcy Yearbook & Almanac* 39 (New Generation Research, Inc. 1997).

professional fees often consume too much of the debtor's estate. The newly complex filing requirements could make the Bankruptcy Code rival the Tax Code in the complexity of its application. Indeed, a "bankruptcy filing industry" like the "tax preparation" industry may evolve to service consumer needs.

Increased costs of bankruptcy. Both H.R. 3150 and S. 1301 would inject numerous opportunities for adversarial hearings in the course of a consumer bankruptcy as debtors and creditors wrangle over the application of statutory terms such as "extraordinary circumstances," "abuse," and "good faith filings." Historically, the mere threat of litigation by creditors against an insolvent debtor "unleveled" the playing field. The cessation of costly legal proceedings is a prime factor for bankruptcy's automatic stay — which is designed to preserve and maximize the bankruptcy estate for all creditors. Therefore, it is reasonable to anticipate that in some instances, debtors who cannot afford creditor-initiated adversarial litigation will acquiesce in reaffirmation agreements, unreasonable repayment schedules, or just opt out of the bankruptcy system. In other instances, frequent adversarial litigation will deplete the debtor's assets available for repayment to all unsecured creditors. The attorneys' fees provisions of S. 1301 may exacerbate, not ameliorate this problem.

Many of the NBRC'S recommendations are intended to streamline and expedite both business and consumer bankruptcies by minimizing their time and expense. Some aspects of the consumer reform proposals may have the effect of transforming consumer bankruptcies into potentially litigation-intensive proceedings.

Implementation costs. The increased responsibilities of the bankruptcy courts with respect to credit counseling, investigatory and verification responsibilities, and auditing will add substantially to the costs of the U.S. bankruptcy court system. It is not clear whether the present fee system would support the revised system.

Mandatory reorganization. The merits of requiring debtors to reorganize as opposed to liquidate their assets have been considered and rejected by the Congress and two bankruptcy commissions. Arguably, those who resort to bankruptcy, in addition to suffering from unanticipated adversity — sickness, loss of employment, etc. — may not be the population most adept at financial planning and management. Are these debtors likely to succeed at five to seven years of tightly budgeted, intensively monitored living, when they are required to do so involuntarily? What would be the practical consequences of fewer bankruptcy filings and fewer successful consumer reorganizations if the actual rate of consumer insolvency remains steady or grows?

The meaning of increased consumer filings. The reforms of "need based" bankruptcy appear to be designed to stem the steadily-increasing tide of consumer bankruptcies.⁸⁰ There also appears to be an assumption that bankruptcy filings are bad — for creditors specifically, and for the economy in general. But alternative scenarios are possible. A fast and expeditious consumer bankruptcy process may, on some levels, inject certainty into debtor/creditor relations. If insolvent debtors refrain

⁸⁰ See CRS Rep. 97-637E, "One Million Personal Bankruptcies in 1996: Economic Implications and Policy Options," by Mark Jickling.

from bankruptcy, will creditors actually receive a greater return on indebtedness? Do the high transaction costs of piecemeal debt collection outweigh whatever advantages fall to creditors when people are insolvent outside of bankruptcy? Bankruptcy process is intended to ensure fairness and maximize returns among competing creditors, not simply to rehabilitate debtors. Will *all* creditors, including small business creditors, capture more or less as a consequence of needs based bankruptcy? Will small creditors with limited legal resources be outmatched by larger creditors with greater resources?

The nexus between the growth of consumer credit and consumer bankruptcy was a development that commanded the attention of the 1970 Bankruptcy Commission and the Congress prior to enactment of the Bankruptcy Reform Act of 1978. The question was asked then, as it is now — does easy credit lead to overextended debtors? The legislative history of the Code paints a picture of consumer credit and increased filings that is analogous to contemporary concerns.⁸¹ If there is a

⁸¹ Discussing consumer debt in 1977, H. Rept. 95-595 at 116, the House Judiciary Committee made the following observations:

Since World War II, the incidence of consumer credit has grown enormously. Consumer finance has become a major industry, and more and more goods have been sold on credit, such as on revolving charge plans. As we have become a consumer society, we have also become a credit society. The Bankruptcy Commission documented the tremendous rise in the amount of credit outstanding for personal, family, or household purposes, and it is not necessary to reiterate those data here.

The result of the increase in consumer credit has been a corresponding increase in the number of consumers who have overburdened themselves with debt. Often, these consumers are able to keep up with their obligations in normal times, but have saved very little for emergencies or unexpected events. When a family member takes seriously ill or when the breadwinner is laid off from his job, a financial crisis ensues....

The vast majority of consumer financial crises are of these kinds. Aggressive advertising and sales techniques by the consumer credit industry, many of whose members rely more on quantity of loans than on the quality to make a profit, add to the problems young families encounter. When the crises finally erupt, the experience of the industry in collecting from overburdened debtors allows it an enormous advantage against the inexperienced and generally distraught consumer. Harsh collection practices heaped on top of already serious financial problems often result in ill health, family strain and divorce, and loss of jobs for many overextended consumer debtors. Bankruptcy often provides the only remedy. Thus, the number of bankruptcies has risen over 2,000 percent in the past 30 years. The rise has paralleled the rise in the amount of consumer credit outstanding.

(Footnotes omitted.)

The 1997 NBRC Report indicates that “[t]he common sense observations of the Congress in 1978 about the increase in consumer debt have been borne out by more statistical
(continued...)

relationship, will erecting obstacles to bankruptcy relief absent tightened standards for consumer lending facilitate or impede commerce?⁸²

Although debtor profiles are studied empirically, it is difficult to know exactly who is filing, and why.⁸³ Consumer credit lenders' oft-expressed concern that debtors engage in prebankruptcy binges of luxury spending are difficult to substantiate. Individuals use credit cards not just for vacations but for medical expenses, tax payments, school fees, groceries, even to start businesses; the end uses of cash withdrawals are also impossible to trace.

As Congress reconsiders the merits of needs based bankruptcy, several underlying questions are likely to be considered. Will needs based bankruptcy increase the bankruptcy distribution to unsecured creditors, or will it simply discourage consumer reorganization? Some keys to the puzzle may lie in determining bankruptcy's role in a robust economy — is its relationship symbiotic to the expanding role of consumer credit, or a pathological manifestation of modern consumerism which needs to be greatly curtailed?

Overview of H.R. 3146, the “Consumer Lenders and Borrowers Bankruptcy Accountability Act of 1998.”

There is speculation over whether the increase in consumer bankruptcy filings is linked to the growth of consumer credit. Some have accused consumer credit lenders of maximizing the extension of credit to high-risk consumers; they are perceived to be “profitable” because, as marginal credit risks they may become heavily indebted and carry large outstanding balances with accompanying high interest rates.⁸⁴

H.R. 3146 would make extensive amendments to the Code which address perceived abuses by consumer credit lenders both in the extension of credit and in their treatment of bankruptcy debtors. The bill also contains provisions designed to curb Bankruptcy Code abuses by consumer debtors. They are surveyed below:

⁸¹(...continued)

analyses since then.” Report, *supra* at 85.

⁸² The NBRC Report recommends repealing the nondischargeability of student loans. Among the reasons cited is a demonstrated lack of correlation between legal nondischargeability and actual loan default: “[A]vailable evidence does not support the notion that the bankruptcy system was systematically abused when student loans were more easily dischargeable. Furthermore, empirical evidence does not support the oft-cited allegation that changes in bankruptcy law entitlements — exemptions, dischargeability, or otherwise— affect the rate of filing for bankruptcy to obtain those benefits.” *Id.* at 213. Footnotes omitted.

⁸³ See, e.g., TERESA SULLIVAN, ELIZABETH WARREN & JAY WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989). See also, the discussion of the rise in bankruptcy filings in the NBRC Report, *supra* note 6 at 82-87.

⁸⁴ See, Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 *AM. BANKR. L.J.* 249 (1997).

Provisions to curb abuses by consumer lenders. H.R. 3146 would amend the Code to disallow certain claims and award attorneys' fees to prevailing parties in specified instances:

- *Discouraging reckless lending practices.*⁸⁵ A creditor's claim must be submitted and "allowed" in bankruptcy. Certain claims are not allowed. The bill would amend 11 U.S.C. § 502 to disallow claims arising from "irresponsible" extensions of credit. Among disallowed claims are: an extension of unsecured credit to an individual which the creditor knew or should have known would cause the debtor's unsecured debts to exceed 40 percent of the debtor's annual gross income; certain secured and unsecured claims which violate the Truth in Lending Act or the Fair Credit Reporting Act; a claim arising from a debt on which the creditor failed or refused to waive interest in an unsuccessful, pre-bankruptcy filing consumer credit counseling plan; and, claims arising from a debt incurred in proximity to a gambling facility that the creditor knew or should have known was to be used for gambling.
- *Stopping creditors' abuses of the bankruptcy system.* The bill would provide for the award of attorneys' fees — in some cases including damages, punitive damages or treble damages — in specified instances. They include: if, at the debtor's objection, the court disallows or reduces (by more than 5 percent or \$500, whichever is less) the amount of an original claim; if a creditor makes an objection to the dischargeability of a debt which the court finds "is not substantially justified"; if a creditor violates the automatic stay; if a creditor files a motion to dismiss on the grounds that the debtor may not be a debtor in the chapter in which the case is pending, or because the filing would be an abuse of the Code, if such motion is denied or withdrawn or is not substantially justified.
- *Reaffirmation agreements and redemption.* A reaffirmation agreement is an agreement between a debtor and a creditor to assume liability of a debt that would otherwise be dischargeable in bankruptcy. 11 U.S.C. § 524(c). Debtors generally enter into reaffirmation agreements to retain valued possessions or to maintain lines of credit. Historically, consumer debtors have been pressured into reaffirmation agreements by creditors, even when doing so may compromise the debtor's financial rehabilitation.⁸⁶ Consequently, reaffirmation

⁸⁵ H.R. 3146, § 2.

⁸⁶ The legislative history to the 1978 Code discusses the prohibition on reaffirmation agreements, which was modified by subsequent bankruptcy amendments:

The bill makes void any agreement that contains a reaffirmation of a discharged debt, and prohibits a creditor from entering into such an agreement. The consumer finance industry strongly opposes this provision. It has argued that debtors frequently voluntarily repay debts, and that debtors should not be prohibited from repaying discharged debts, out of a sense of moral obligation or for other reasons. "Voluntary", however, is somewhat euphemistic, and often has

(continued...)

agreements are scrutinized by the bankruptcy courts to ensure that the debtor has entered into it voluntarily and with knowledge of its consequences. A chapter 7 debtor is required, shortly after filing, to inform creditors of the debtor's intentions with respect to secured consumer debts, *i.e.*, whether the debtor intends to surrender or retain the property, and whether the debtor intends to reaffirm the debt or redeem the property by lump sum payment. 11 U.S.C. § 722. In some instances, a debtor has not declared his intention to reaffirm a debt, but has maintained payments and remains current with respect to it. The courts have split over the impact of the debtor's failure to make a formal declaration of an intention to reaffirm a debt when the debtor remains current on payments — which is sometimes referred to as a “ride-through”.⁸⁷ H.R. 3146 would permit a debtor to redeem property through installment payments rather than a lump sum payment. It would eliminate reaffirmation agreements.

- *Increased incentives for voluntary repayment plans.*⁸⁸ The bill would amend the Fair Credit Reporting Act, 15 U.S.C. § 1681c, to provide when a consumer debtor under either chapter 12 or 13 successfully completes a reorganization plan, the fact of a bankruptcy filing may only be reported by credit reporting companies for five years instead of the current ten year reporting period; bankruptcy courts could not impose minimum payment requirements to determine whether a debtor's proposed reorganization plan is proposed in good faith; and, the duration of a chapter 13 plan could not exceed three years unless the debtor proposes a five-year repayment plan.
- *Preventing windfalls for undersecured creditors.*⁸⁹ This provision would revise lien avoidance guidelines affecting a debtor's exempt property. It would void any lien on the debtor's interest in any personal or household item unless the lienholder files a sworn declaration that the item's purchase price exceeded \$1,500. It would also treat rent-to-own contracts as purchase contracts.

Provisions to curb abuses by consumer debtors. Several provisions of H.R. 3146 are intended to address consumer “abuse” of the bankruptcy laws. These provisions include:

⁸⁶(...continued)

led to court action to enforce “voluntary” repayments. The bill recognizes the truly voluntary situation and permits legitimately voluntary repayments, but denies creditors court process to enforce a reaffirmation other than under a nondischargeability or redemption agreement. H.R. 8200 guarantees that debtors may repay a portion or all of a discharged debt in a voluntary situation, without any fear of reaffirming the whole of the debt and being subject to the same court process that resort to the bankruptcy laws was designed to prevent.

H.R. Rep. 95-595 at 164, *supra*. Footnotes omitted.

⁸⁷ See note 58 *supra*.

⁸⁸ H.R. 3146, § 6

⁸⁹ *Id.*, § 12.

- *Provide fair property exemptions and prevent “high-rollers” from abusing the system.*⁹⁰ This provision would modify the bankruptcy homestead exemption guidelines to deny an exemption in excess of \$100,000 for certain pre-bankruptcy property conversions when an insolvent debtor converts property into a homestead exemption under state law. It would also establish the existing federal exemptions as a uniform national *minimum* exemption to promote greater equity among those states which limit residents to state law exemptions and which vary enormously in exemptible amounts.
- *Prevent abuse of the bankruptcy system by debtors who can afford to pay their debts.*⁹¹ This provision would revise the criteria under § 707(b) for dismissal of cases for abuse. The bill would replace the “substantial abuse” standard with “abuse” and define it to encompass debtors who could pay all of their unsecured nonpriority debts over thirty-six months, or as they become due; it would preclude a finding of abuse if the debtor’s household income does not exceed \$60,000, adjusted for household size.
- *Prevent abusive bankruptcy filings.*⁹² This provision would specify circumstances under which the bankruptcy court could terminate the automatic stay against the debtor’s creditors to prevent abusive repeat filings. It would deny a chapter 7 discharge to a debtor who makes intentional and material omissions from the schedule of debtor assets.

⁹⁰ §Id., § 7. The term “high rollers” is not defined.

⁹¹ Id., § 8.

⁹² Id., §§ 9, 10.