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BANKRUPTCY REFORM ACT OF 1998
PART I

TUESDAY, MARCH 10, 1998
House of Representatives,
Subcommittee on Commercial and Administrative Law,
Committee on Judiciary,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:00 a.m., in room 2141, Rayburn House Office Building, Hon. George W. Gekas (chairman of the subcommittee) presiding.

Present: Representatives George W. Gekas, John Conyers, Jr., Jerrold Nadler, Sheila Jackson Lee, and William D. Delahunt.

Also present: Raymond V. Smietanka, chief subcommittee counsel; Susan Jensen-Conklin, subcommittee counsel; Susana Gutierrez, subcommittee clerk; Diana L. Schacht, deputy staff director-committee counsel; Perry Apelbaum, minority general committee counsel; Peter Levinson, committee counsel; and David Lachmann, subcommittee professional staff member.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. **GEKAS** [presiding]. The hour of 10:00 having arrived, the subcommittee will come to order.

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As everyone anticipates, this is an important stop on the way to final consideration of bankruptcy reform for the current term of Congress. Present with us, constituting the hearing quorum, is the gentleman from Massachusetts, Mr. Delahunt, which means we have the required number of members to proceed with our hearing. Before we do, a brief summary of how we got here would include a dissatisfaction, generally, across the Congress and across the land with the results of the Bankruptcy Reform Act of 1978, which then resulted in various amendments by the Congress of the United States.

And, finally in 1994, Congress decided to create a commission to look into some of the facets of the Bankruptcy Code to see if it could be reformed. After a 2-year study by the Bankruptcy Review Commission, the final report of which was filed last October, the subcommittee, which has jurisdiction over bankruptcy, is in a position to review the same. As we began our review, we came upon startling new statistics that indicated that the 1978 bankruptcy reforms obviously had not worked. As the Commission's work was coincident with these statistical developments, it could not properly deal with them. We were all shocked to learn about the 1.4 million new bankruptcies filed in 1997, which were piled onto the more than one million filings in 1996; thus, giving us a kind of agitation that was not reflected in the work of the Bankruptcy Commission, itself.

And, so, with the ideas of the gentleman from Florida and Virginia, Mr. McCollum and Mr. Boucher, having caught fire across a large cross section of the Congress, with respect to establishing a needs-based theme for bankruptcy reform, we were able to set our sights on these new, horrible bankruptcy filing statistics.

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This, together with the beneficial parts of the Commission report, became our compendium of ideas that are reflected in H.R. 3150, the main bill that is before us. In the meantime, the gentleman from New York, Mr. Nadler, the ranking minority member of this subcommittee, together with other co-sponsors, have also introduced a bill, which is before us, even though the chair prefers H.R. 3150—and I won't go into the reasons why. And, so, the testimony today will center around the general concept of what is contained in H.R. 3150, and in the other pieces of legislation. I must say, and I have said this countless times, there is nothing, absolutely nothing in H.R. 3150 that would prevent an individual, who becomes inundated with debts so far over his head that there is no escape and his family would be devastated, from getting a fresh start.

As a matter of fact, we believe that we've improved the prospects of an individual or a family that faces such dire straits. They would be able to receive a full discharge of debts more easily, in some respects, than under current law. But, at the same time, we will provide, with the passage of this legislation, a mechanism to identify those who are able to pay some or all of the debt back over a protracted period of time, with as much lenience as possible for the circumstances of each family. That result will have better prospects under the bill that we are now considering. Indeed, if some of the debt can be repaid, then we will have succeeded in this venture.

With that, I would yield to the gentleman from Massachusetts, if he wishes to make an opening statement.

Mr. **DELAHUNT.** Well, it's really not an opening statement, Mr. Chairman. It's an observation. And, I want to compliment the Chair and the staff, both from the majority and the minority side for the hard work that they have put into this particular issue. At the same time, I'm looking at today's schedule and I see five panels, and I would obviously defer to the expertise of the Chair and to other members of the subcommittee who have considerable expertise and much more familiarity with the issue of bankruptcy than I do. As the Chair well knows, I'm a new member, and I probably have a larger learning curve than most.

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However, at the same time, five panels is, I would suggest, a rather large number of witnesses to testify during the course of one hearing. For those of us who are trying to lower that learning curve, if you will, to try to listen, assimilate, and reflect and learn, I would ask the Chair, in the future, to consider having maybe one or two panels. I think it would be significantly more beneficial for the members of the subcommittee in terms of educating themselves, and also educating the audience, and anyone who might be watching on C–SPAN.

Also, I'd asked the Chair—I've requested the transcripts of previous testimony, and at this point in time, I've been told that, well, they're simply unavailable. And, I would hope that the Chair would instruct the staff, or whoever is responsible for providing those copies, to accelerate that process.

I'd also respectfully remind the Chair that at one of the earlier panels, several witnesses testified to the fact that it was 5 years of hearings that resulted in the last reauthorization of the Bankruptcy Code. Now, I learn today from majority staff that the subcommittee, or you, Mr. Chairman, hope to have a bill marked up prior to April recess. If you could just provide for me, and other members on this side, what your plans are in terms of this particular proposal. I think it would go a long way to give us some context.

Mr. **GEKAS.** I thank the gentleman——

Mr. **DELAHUNT.** I yield back.

Mr. **GEKAS.** I thank the gentleman. The fact that we have several panels for today and others scheduled for next time around, which would be Thursday of this week, and then next week, is for exactly the same purpose about which you lament. That is, to give you as much information from as many angles as possible, as quickly as we can so that the curve about which you speak would be expanded and——

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Mr. **DELAHUNT.** I appreciate that. If the gentleman will yield——

Mr. **GEKAS.** So that's the main reason for—wait.

Mr. **DELAHUNT.** If the gentleman will yield, I appreciate that, but I know, speaking at least for myself, and I'm sure for several other members of the subcommittee, to be able to absorb and reflect and analyze the information in the testimony that we're going to hear is going to take some time. We have a schedule today that is busy. There are other hearings going on simultaneously, and I really fail to see the need to put five panels on a day where maybe two or three would suffice. In my entire 15 months in the House of Representatives, I have never sat on a subcommittee or a full committee where there has been testimony from five different panels, and I would ask——

Mr. **GEKAS.** There's always the first——

Mr. **DELAHUNT.** There's always the first time, that's true.

Mr. **GEKAS.** And, the gentleman is an accomplished attorney and former prosecutor. He is well able to assimilate as much information as is credible that comes from——

Mr. **DELAHUNT.** Well, I thank you for the compliment, Mr. Chairman, but you're exaggerating my abilities.

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Mr. **GEKAS.** And your other suggestion will be well-taken, and I will issue directions to the staff to make sure that the request for copies of testimony or any other request of any member of the subcommittee be fulfilled as quickly as possible.

With that, we will proceed with the testimony of our colleagues.

Mr. **DELAHUNT.** I'd yield to the Ranking Member, if it's my time.

Mr. **GEKAS.** The gentleman from New York is now accounted for.

Mr. **NADLER.** Thank you, Mr. Chairman. I apologize for being late. I had to introduce a nominee to the Federal Trade Commission at a Senate hearing this morning, confirmation hearing.

Mr. Chairman, today we begin hearings on what promises to be a spirited debate on the issue of consumer bankruptcy. This is an issue which deeply divided the National Bankruptcy Review Commission. Perhaps, the only thing they could agree on was that adequate data on bankruptcy filings are not now collected, aggregated, and made available. As the Commission stated in its report, and I quote: "now policy and decisionmakers are too often left largely with anecdotes as the primary basis for their conclusions and proposals. The empirical studies that do exist are based on a small sampling that has been manually and laboriously compiled, and the conclusions of these studies cannot be updated without similar effort." Page 924.

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The chairman is recognizing the importance of improved data collection and has included provisions requiring improved data collection in his bill. Today we will hear a great deal of discussion about the number of bankruptcies, the causes for the increased rates of bankruptcy, and what the legislative response should be. We will be presented with a great many new studies, most of which have been funded by the credit card industry.

As we listen to this discussion, I would hope that the members of the subcommittee remember that we are talking about 1.3 million American families just last year. They find themselves in the bankruptcy courts for a variety of reasons. But, I would caution members not to be too quick to dismiss their predicaments. They are the women left alone with children and no child support. They are middle class families caught with a mortgage in the middle of a corporate downsizing. They are the residents of communities whose industries have left town in search of slave wages, child labor, and repressive regimes abroad. They are the family whose breadwinner has gotten sick and cannot afford to go to the doctor because they lack health insurance.

These are not new problems. We debate them every day, and they have real consequences for real families. Those families are our neighbors, so I would hope that there will not be a rush to brand those millions of American families as crooks or slackers. It is unfair, and it's not true, for the most part.

Now are there people acting irresponsibly? Gaming the system? I think we can all agree there are some. Our job is to preserve the integrity of the bankruptcy system, without losing sight of its success, in fostering an economic way for debtors and creditors to deal with each other. We must ensure fairness, a fairness in which each individual family situation can be considered, and we must maintain the ability of people who are in trouble to rejoin the mainstream economy, and not to be pushed into permanent debt peonage or into the underground economy. That's not good for them and it's not good for the country.

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But, while we're on the subject of individual responsibility, we need to look at both sides of the equation—at the debtors and at the creditors. I do not think, for example, that a creditor, who makes a subprime loan to a debtor who is already clearly in over his head, should necessarily be allowed to have the taxpayers bail out his reckless business activities. I certainly do not think that such a lender should be rewarded by being allowed to share equally in the debtor's limited resources with another lender, who did his or her due diligence before making the loan. I'm also concerned that if we make subprime, unsecured, non-priority debts non-dischargeable, as the chairman's bill would do in certain situations, we would be robbing precisely those non-dischargeable debts of resources which Congress has rightly decided deserve priority treatment.

Money owed for certain taxes, for child support, or to pay a debt caused by a drunk driving accident fall into this category. In fact, the House voted for the second time last year to expand that last exception to planes and to boats. Do we really want child support fighting for those post-discharged dollars with a negligent creditor? That's what we might do. That's what some of the provisions of this bill—of the chairman's bill would do, and I believe it would be a mistake.

Finally, Mr. Chairman, I would like to make a personal appeal to you. In the past, bankruptcy reform has been a collegial, a bipartisan, a careful, and a deliberative process. Unfortunately, for whatever reason, the minority in the subcommittee has a great difficulty finding out the subject matter of hearings, the identity of the proposed panels, until very late in the game. We have had difficulty participating in the process because it has not been as open and cooperative as it traditionally has been.

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I'm also concerned by the unusually short time line that has been set for this process. You've proposed a subcommittee markup by March 25—a little more than 2 weeks away. The majority leadership has scheduled bankruptcy legislation for consideration on the floor in April. We have never, even when there was broad bipartisan agreement on the underlying policy, moved bankruptcy legislation at that kind of a swift pace, and with good reason. The Bankruptcy Code is complicated, and the risk of inadvertent harm is great.

The 1973 Bankruptcy Commission's recommendations were not enacted until 1978, and there was far less lobbying and disagreement concerning the recommendations of that report. That Commission even proposed legislative language, something this Commission—the recent Commission did not do. So, especially on an issue where the facts and equities are so clearly in dispute, we should exercise great caution.

I do not ask that we delay for 5 years, as was done in the 1970's, but I do ask that we proceed with due deliberation, due caution, and due consideration. In that spirit, Mr. Chairman, I would ask that we have a chance to sit down, the minority and the majority, on a bipartisan basis, after this hearing, to discuss the next set of hearings. I think, together, we can work out an approach for these important questions that will create a full and helpful record for the House, and perhaps, as it has in the past, will facilitate bipartisan cooperation.

I hope, for example, we can take a day, or at least part of a day, to hear the views of the Nation's leading bankruptcy organizations, such as the National Bankruptcy Conference, the American College of Bankruptcy, the National Conference of Bankruptcy Judges, and the Commercial Law League of America, as we have always previously done when considering bankruptcy legislation. So, I must earnestly urge you to consider this request. I thank you, Mr. Chairman.

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Mr. **GEKAS.** The Chair is fighting back a flood of possible umbrage at the suggestions made by the ranking member that we have been uncooperative and uninforming. And, to that extent, whatever has happened between staffs, or between the gentleman from New York and myself, I will be glad to put aside and adhere to some of the suggestions made by the gentleman from New York.

We have attempted to structure a witness list that would be fair, and we are the ones who made suggestions to put opponents of H.R. 3150 on the panel right at the outset, while giving due respect to the minority's choice of witnesses from the very first. But, having said all that, I don't want to engage in an argument. Now, I will sit down with the gentleman from New York and we will work it out. We will try even to have a full day, maybe Sunday, for all the subcommittee to sit down and try to plan the hearings together.

Mr. **NADLER.** Well, I thank the chairman, though I urge it not be Sunday.

Mr. **GEKAS.** We'll turn to our colleagues who have waited patiently through this tornado. We have with us three distinguished colleagues, with whom we have worked with on many different subjects over the years, but for these particular purposes have a special place in our judgment of colleagues and their interest in current legislation. We have the gentleman from Florida, Mr. McCollum, Mr. Boucher of Virginia, and Mr. Moran of Virginia.

In their own ways, they have contributed mightily to the subject matter at hand. As a matter of fact, the bill they introduced at the outset of this debate, that was brewing through all of 1997, forms the basis of the consumer portion of H.R. 3150. For that alone, we are indebted to the gentleman. We hope that we will do justice to the formation of your ideas as we proceed along the path of enacting legislation, and until then, we're prepared to hear your views. The gentleman from Florida.

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STATEMENT OF HON. BILL McCOLLUM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. **MCCOLLUM.** Thank you very much, Mr. Chairman. I, first of all, want to commend you for the bill that you've introduced, H.R. 3150. It is an excellent product, in my judgment, and I greatly appreciate, as I know that the two gentlemen to my right do, the fact that you've worked with us, particularly on the consumer provisions that were very much similar, if not identical, in many cases to our initiative in H.R. 2500

I think the salient point this morning that needs to be driven home about bankruptcy is the latest statistics that came out here just a couple of days ago, showing an even greater percentage of personal bankruptcy filings in the last year, 1997, than had been predicted. The study shows that 23 percent increase occurred in 1997. I think there were projections of maybe a 20 percent increase. That's on top of, more than 100 percent increase in personal bankruptcy filings from 1986 to 1996, an almost 400 percent increase overall since 1980. Now, that's just way too many personal bankruptcy filings in a considered period of time when the personal, real per capita income went up at least during the 10-year period of 1986 to 1996, some 13 percent, and 70 percent of all of those personal bankruptcy filings were straight chapter 7—the plain vanilla, we're going to get rid of all of our debt, discharge it, and be done with it type—rather than chapter 13, which is what, I think, many people believe, most Americans, if they can afford to, should be filing, which is the protection you get, as the chairman well knows, where you actually pay back a good portion of your debt if you can afford to do that and still have the protection of the bankruptcy court.

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My judgment on all of this is that that's the primary reason why we need to going to a needs-based test. The old-time modern stigma that normally would discourage people from total, absolute bankruptcy seems to have disappeared somewhere in society. We have bankruptcy attorneys today, as opposed to when I practiced some limited bankruptcy law, at least in the Navy portion of my career, where attorneys then would urge the payback portion to come first. They today seem to be very quick on the trigger to seek advice and suggest that people file pure chapter 7 bankruptcies.

And, so, what we have worked together, Mr. Boucher, myself, Mr. Moran on, is a proposal that drafted into H.R. 3150 that would say that, if you have the ability to pay back, and you have at least 75 percent median family income that your family is earning, which in the case of a family of four is around $39,000 a year, that you be channeled, if you meet a certain test, into a position where you have to go to payback or chapter 13 route. And, that is, in my judgment, the most significant and most important thing that needs to be protected as you go through your mark-up period of that principle and that concept, though there may certainly be details and variations on it.

Last, but not least, along that line, I'm sure I'm reiterating for your benefit, but more for anyone else here whose attending, the formula is very simple. Some people have complained, well, maybe we're adding some complexity to the law. We're actually not. We're adding simply a little checklist that everybody's going to have to go through in bankruptcy court when they first file. Hopefully, their attorneys go through it with them first, where they say, "What is our monthly gross income?" And, if that family has a monthly gross income that is great enough that qualifies them to be tested, if you will, then you subtract from that, in this test, the amount of their monthly payments for their secure debt, their car, their home, or whatever; and then you subtract from that any court obligations, like alimony and child support for that month; then you subtract from that the monthly living expenses, as calculated under the Internal Revenue Service Code, and if you have $50 a month or more left over, and then you can pay off on an extrapolated basis, 20 percent or more of your debt over the next 5 years, your unsecured debt. You must file, and can only file chapter 13, and pay back some of your debt.

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I would encourage the subcommittee to keep that provision as basic formula in this markup, when it's all said, and I would certainly strongly urge the subcommittee to work within that general framework because we do need a needs-based test. We need to do something to encourage people to pay off their debt, if they can afford to, or at least pay off a portion of it, rather than costing consumers—which is what we're doing now—something like $40 billion last year, which in the way that it's spread out, undoubtedly, means higher interest payments for those who, indeed, can afford it, and do normally pay back their debts, and credit cards, and so forth. It certainly means a lot more to them perhaps in other ways as well.

I thank the chairman, and my complete statement, I'm sure, is in the record.

[The prepared statement of Mr. McCollum follows:]

PREPARED STATEMENT OF HON. BILL MCCOLLUM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, thank you for providing me with an opportunity to testify on needs-based personal bankruptcy reform as outlined in H.R. 2500 and included in H.R. 3150. I appreciate the time and attention the Chairman has dedicated to this important issue and commend him for holding these hearings.

H.R. 2500, the Responsible Borrower Protection Bankruptcy Act, was introduced in September of last year as it became clear that reform of the existing bankruptcy system was sorely needed. At the time the bill was introduced, our nation was witnessing an epidemic of personal bankruptcies. From 1986 to 1996, real per capita annual disposable income grew by over 13 percent but personal bankruptcies more than doubled. In 1996, for the first time ever, there were more than 1 million personal bankruptcy filings. In fact, bankruptcies have increased over 400 percent since 1980.

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It was estimated that personal bankruptcies would rise by 20 percent in 1997 to 1.3 million personal bankruptcy filings. In fact, the increase in personal bankruptcy filings in 1997 was even larger than expected, with the Administrative Office of the Courts reporting over 1.4 million personal bankruptcy filings, constituting a 23 percent increase. That is more than one bankruptcy per every 100 American households.

Mr. Chairman, what is most disturbing about this rate of increase is the fact that it is occurring at a time when the nation is experiencing a robust economy with the lowest unemployment rate in more than 20 years. If we do not address personal bankruptcy reform now, while the economy is doing well, the problem will only become worse during a recession.

The Responsible Borrower Protection Bankruptcy Act, H.R. 2500, fundamentally reforms the existing bankruptcy system into a needs-based system. Only those who truly cannot repay their debts will be able to use the complete bankruptcy in Chapter 7 of the Bankruptcy Code. Those who can repay their debts will have to use Chapter 13 and work out a repayment plan.

Needs-based reform is intended to address a flaw in the current bankruptcy system which encourages people to file for bankruptcy and walk away from their debts, regardless of whether they are able to repay any portion of what they owe, by using the straight bankruptcy of Chapter 7. Under the current bankruptcy system, the vast majority of those who file are not even examined to determine if they are able to repay even a portion of what they owe. Such a misuse of our bankruptcy laws is fundamentally unfair to those who play by the rules and take responsibility for their personal obligations. Needs-based reform would directly address this flaw by requiring that those who have the ability to repay file in Chapter 13 and work out a repayment plan.

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H.R. 2500, as well as H.R. 3150, outlines a formula for determining ability to repay which takes into account income, debts, and expenses. Those who make less than 75 percent of the national median family income, depending on family size, will be presumed unable to repay their debts and may file complete bankruptcy. But those who make more than 75 percent of the national median family income, depending on family size, and, according to a formula, are able to pay at least $50 per month toward debt reduction of at least 20 percent of their unsecured, non-priority debt over five years may only file in Chapter 13.

More and more, people see bankruptcy as a financial planning tool, spurred on by advertisements promoting the irresponsible use of Chapter 7. Also, the social stigma associated with filing for bankruptcy has eroded. Bankruptcy was never meant to be used as a financial planning tool or for mere convenience. These "bankruptcies of convenience" are a clear misuse of the bankruptcy system, as bankruptcy becomes a first stop rather than a last resort.

Mr. Chairman, our nation's bankruptcy laws play a vital and necessary role in our society. We must ensure that our bankruptcy system does not encourage those who can take responsibility for their debts not to do so. Under the current system, about 70 percent of those who file for personal bankruptcy file in Chapter 7, while only about 30 percent file in Chapter 13.

The flaws in the current system, combined with the weakening social attitudes toward bankruptcy, have contributed to the surge in filings. The explosion of bankruptcy filings is hurting responsible borrowers across the country. Bankruptcy is expected to cost our nation $40 billion in 1997. That translates into over $400 per household in higher costs for goods, services and credit. Here's what $400 means to every American family of four: five weeks of groceries, 20 tanks of unleaded gasoline, 10 pairs of shoes for the average grade-school child or more than one year's worth of disposable diapers.

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Needs-based bankruptcy reform will protect those responsible borrowers who pay their debts and protect them from those who misuse our bankruptcy laws. In fact, it has been estimated that 15 responsible borrowers are needed to cover the cost of a single bankruptcy.

It should be noted that all three bills which we are discussing today, H.R. 2500, H.R. 3150 and H.R. 3146, propose some form of needs-based reform. There are, of course, large differences in our approaches but it clearly shows that there is a clear consensus: the nation's bankruptcy laws should not promote irresponsible behavior by allowing those who have the ability to repay to walk away from their debts.

H.R. 2500 and H.R. 3150 also reforms the bankruptcy system to reduce repeat filings and to prevent the gaming of the bankruptcy system, such as running up credit bills right before filing for bankruptcy or filing and dismissing a bankruptcy case as a stalling tactic. Other provisions will improve the administration of bankruptcy cases, increase oversight, and provide debtors with information about alternatives to bankruptcy, such as credit counseling services. By ensuring that our bankruptcy laws are not abused, we also ensure that bankruptcy remains a viable last resort for those who have tried to pay their debts but are driven by adverse circumstances to ask for judicial intervention.

If Congress fails to fix the flaws in the current bankruptcy system now, then responsible borrowers will continue to pay the price. Mr. Chairman, I am confident that, under your leadership, these two days of hearings will make it clear that adoption of the needs-based personal bankruptcy reforms outlined in H.R. 2500, and included in H.R. 3150, is vital to ensuring that our bankruptcy laws operate fairly, efficiently and free of abuse. I commend the Subcommittee for tackling this important issue and look forward to continuing to work with you in addressing this issue.

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Mr. **GEKAS.** Yes. The written statements will be accepted for the record, without objection. The gentleman from Virginia, Mr. Boucher, is recognized.

STATEMENT OF HON. RICK BOUCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. **BOUCHER.** Mr. Chairman, thank you very much. I want to express appreciation for inviting our testimony this morning, and also commend your introduction of H.R. 3150, and the many much-needed changes in the Nation's bankruptcy laws that it contemplates. I am very pleased to be joining with my colleagues at this table, and being your co-sponsors for that bill.

As Mr. McCollum indicated, your legislation incorporates the needs-based provisions for the use of chapter 7 that we put forward last year in H.R. 2500. And, I think it's noteworthy that H.R. 2500, largely because it contains that needs-based test for the use of chapter 7, now has approximately 180 co-sponsors in the House and it has a very broad bipartisan base. In fact, about one out of every five Democrats in the House is a co-sponsor of that bill today.

That reform, and the bankruptcy laws, is badly needed and is absolutely essential. As Mr. McCollum indicated, the numbers of the filings of personal bankruptcy petitions are increasing dramatically. We had about a 23 percent increase in 1997 alone, over 1996, and you would have expected exactly the opposite to occur. In 1997, we had one of the strongest economies that we've had in decades. Unemployment figures have dropped to about a 30-year low; that report came last week. So you would have expected exactly the opposite to occur—lesser bankruptcy filings rather than more. And, yet, in that year of a strong economy, we had a 23 percent increase over the level for 1996.

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So, why are these dramatic increases in bankruptcy filings occurring? Well, I think there are several reasons.

First of all, unfortunately, I think, many people in our society today are viewing bankruptcy as a first resort rather than a last resort. The stigma that used to attend the filing of a bankruptcy petition in the minds of many, simply, no longer exists. So people feel relatively free to treat bankruptcy as a matter of convenience, and simply treat it as another financial planning tool. If it's easier to file for chapter 7, and wipe out the debts, and start with a clean slate, than not, many people choose that course.

Bankruptcy was never intended to function that way. It was always designed to be a last resort. And, the bill that you have put forward would restore the use of chapter 7 to its originally intended purpose, and make sure it's available for those who really need it. But, for those who could repay a significant portion of their debts, they would be required, if they still want bankruptcy protection, to use the court structured and supervised repayment plans of chapter 13. And, that change, Mr. Chairman, will benefit all consumers of products and services, and it will benefit all responsible borrowers.

Each year, today, approximately $40 billion in consumer debt is wiped out in bankruptcy filings. And, that loss is directly reflected in the price that businesses have to charge for products and services, and that loss is directly reflected in the price that lenders have to charge for credit. And, the combination of these costs imposes an estimated $400 in a hidden tax on the typical American family every year.

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Your bill, Mr. Chairman, will significantly lessen that burden. And, since that $400 per family per year is a hidden tax, I think we can say with confidence, that your bill is a tax relief act.

Today, some people who are wealthy are seeking the shields that are offered by some states through their homestead laws. And, your bill also, I think effectively, addresses that concern. Some states have homestead laws that enable the sheltering of a very large amount of wealth simply through the purchase of a personal residence. And, since the Federal bankruptcy laws acknowledges and respects the homestead laws that exist in the various states, some people are able to gain the system and shelter a great deal of wealth simply by buying an expensive residence.

You, Mr. Chairman, I think, effectively addressed that concern by providing that, before an individual can use the state's homestead law as a shelter in that person's bankruptcy filing, the person must have been a resident of the state for at least 1 year. That, I think, is a very constructive and important change, and I hope that that's a part of the final product that your subcommittee reports.

Mr. Chairman, it's a pleasure to join with you in this effort and I'll look forward to working with you at full committee to approve this measure, and also to obtain its passage in the House.

Mr. **GEKAS.** I thank the gentleman, and we'll turn to his colleague from Virginia, and our colleague, Jim Moran.

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STATEMENT OF HON. JAMES P. MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. **MORAN.** Well, thanks very much, Mr. Chairman, and members of the subcommittee. This is an important bill because the current bankruptcy system is broken. Somewhere over the past decade, the integrity of the bankruptcy process has been corrupted, and an important moral principle has been eviscerated. The time-honored principle of moral responsibility and personal obligation to pay one's debts has been eroded by the convenience and the ease with which one can now discharge his or her obligation. What was once the option of last resort, has too often become the preferred option of first resort.

A legislative fix is vital to distinguish between those who truly need a fresh start, and deserve one, and those capable of assuming greater responsibility and making good on at least some of what they owe. That's why we need needs-based bankruptcy reform. It's unbelievable when you hear the statistics that my colleagues and you have cited, that we have almost 1.4 million bankruptcies in a year when we have as good an economy as we've ever had. Interest rates are down. Incomes are up. Growth is up. Why do we have as many bankruptcies as we do? It doesn't make sense.

More people filed for personal bankruptcy last year than graduated from college. That's wrong. Instead of bankruptcy being a safety net, it's become a convenient financial management tool. That's why we need this legislation. It's unacceptable and it's unfair that those who do pay their bills have to foot the bill for those who, in many instances, have the ability to pay, but choose not to.

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It's been conservatively estimated that personal bankruptcy cost every household, in this country, $400 per year. The decent, responsible, honest people are paying for those who are not. And, it takes 15 responsible borrowers to cover the cost of one banker fee of convenience. The system will continue to be void of integrity if debtors persist in using it as a tool of first resort. It was never intended to be a tool of first resort. It should be a tool of last resort, when every other option has been exhausted. This Nation's bankruptcy system is broken because it enables people to avoid paying their debts when they can afford to, and that's what this legislation is all about. I'm not going to belabor that point, but that's the underlying issue.

Seventy-six percent of Americans believe that individuals should not be allowed to erase all of their debt in bankruptcy if they are able to repay a portion of what they owe. We know that. That's just common sense, and it's basic tenant of our system. So we want to go to a needs-based system, and, you know, when you talk about low income people, we exclude low income people. We take care of them. The average bankruptcy filer earns approximately $34,000 a year.

But, we don't apply this to people whose incomes are less than 75 percent of the National median income, by family size. For a family of four, that's 75 percent of National median income, it's almost $39,000 per year. So, most people are excluded. What we're trying to get at is those who have money and who are avoiding paying their debts, and then causing the rest, the working class families, to have to pick up that cost.

It's not a matter of credit cards, necessarily, although too many people are charging too much on credits cards, I think that would be generally recognized, but 96 percent of credit card holders pay their bills. Only 1 percent ever end up in bankruptcy, and, in fact, bank credit cards only represent one-sixth of total debt in the average bankruptcy petitions. So, that's not the main problem.

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This is a consumer-friendly bill. We've got a debtor's bill of rights; it enables you to protect yourselves from these bankruptcy mills that are proliferating across the country. That's why we have over 170 sponsors to H.R. 2500, which was the first bill, and is now incorporated in this bill—a record bill. I've been pushing this for years, as I know you have, Mr. Chairman. I think that we've got a good bill here because it's good for the American people. It's in their interest to support this bill. It ought to be bipartisan, and I'm confident it's going to be bicameral, and I would hope that it would passed this year, because it can be passed not too soon for those honest, good Americans who shouldn't be paying $400 a year to bail out people who are abusing the system. Thank you, Mr. Chairman.

[The prepared statement of Mr. Moran follows:]

PREPARED STATEMENT OF HON. JAMES P. MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

INTRODUCTION

Chairman Gekas, Members of the Subcommittee, thank you for allowing me to come before you today to speak on behalf of the Bankruptcy Reform Act of 1998 (H.R. 3150). I am sponsoring this bill with Chairman Gekas because the current bankruptcy system is broken. Somewhere over the past decade, the integrity of the bankruptcy process has been corrupted and an important moral principle has been eviscerated. The time-honored principle of moral responsibility and personal obligation to pay one's debts has been eroded by the convenience and ease with which one can discharge his or her obligations. What was once the option of last resort has too often become the preferred option of choice.

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A legislative fix is vital to distinguish between those who truly need a "fresh start" and those capable of assuming greater responsibility and making good on at least some of what they owe. I look forward to working with this Committee to bring needs-based bankruptcy reform to fruition this year.

THE SYSTEM IS BROKEN AND LACKS INTEGRITY

Despite this country's strong economy—wages are up, unemployment is down, and interest rates and inflation are low—the rate of personal bankruptcy filings has increased dramatically. Last year personal bankruptcy filings rose nearly 20 percent reaching a startlingly record high of more than 1.3 million filings. More people filed for personal bankruptcy than graduated from college last year. Instead of bankruptcy being a safety net, it has become for some a convenient financial management tool. The Bankruptcy Reform Act will help to bring this equation back into balance.

I find it unacceptable and inherently *unfair* that those who do pay their bills have to foot the bill for those who, in many instances, have the ability to pay, but choose not to. It has been conservatively estimated that personal bankruptcies cost $400 per household per year, and it takes fifteen responsible borrowers to cover the cost of one bankruptcy of convenience. The system will continue to be void of integrity if debtors persist in using it as a tool of first resort rather than a tool of last resort when all other financial options have been exhausted. Clearly, this nation's bankruptcy system is broken when it enables individuals to avoid paying their debts despite their ability to do so. What this Congress must do is to undertake genuine needs-based bankruptcy reform to require those who have the ability to repay a portion of their debts to enter a Chapter 13 repayment plan, while also preserving the historic "fresh start" in Chapter 7, for people who have fallen on hard economic times. The goal of our bankruptcy system has always been to protect those who need protecting—to provide those who experience genuine and serious financial hardship the opportunity to wipe the slate clean. What we must do is return our system back to its original mission through a simple legislative fix.

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BANKRUPTCY REFORM IS A CONSUMER ISSUE BECAUSE IT PRESERVES THE "FRESH START"

Bankruptcy reform is not a Republican or a Democrat issue—it is a consumer issue. According to the National Consumer League's 1997 survey, 76 percent of Americans believe that individuals should not be allowed to erase all of their debts in bankruptcy if they are able to repay a portion of what they owe. This survey merely reflects the American public's belief that individuals should be responsible for their own actions. Our bill would help to remedy the glaring problems of today's bankruptcy system by creating a needs-based system which would continue to protect the rights of those citizens who need a fresh start, while at the same time requiring those who don't to carry their fair share of the load.

It has been argued that such an approach—a needs-based system—will disproportionately hurt low income groups. First let me say that low income debtors are simply not filing for bankruptcy in large numbers. In fact a recent study found that counties with low average incomes have the lowest bankruptcy filing rates per capita. The average bankruptcy filer earns approximately $34,000 a year.

The needs-based bankruptcy system, as outlined in the Bankruptcy Reform Act, does not prevent anyone from receiving bankruptcy relief. In fact, the needs-based approach applies only to debtors with an income of greater than 75 percent of the national median income by family size and the ability to repay at least 20 percent of total unsecured debt out of income, which exceeds what is needed to cover secured debt, prioritized unsecured debt, and living expenses. Individuals or families with an income below 75 percent of the national median income are not affected by the needs-based approach. Currently, 75 percent of the national median income for a family of four is $38,639.

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Moderate and low-income families are not the target of this legislation, but they may be the victims of restricted credit if we do not fundamentally reform the present system. Because of the rise in bankruptcies, financial service companies, even credit unions, may be left with little recourse but to restrict the credit currently available to those low-income families who need it most.

CREDIT CARDS ARE NOT THE REASON FOR THE INCREASE IN BANKRUPTCIES

Despite all the anecdotal evidence to the contrary, the credit card industry is not the impetus for the bankruptcy crisis in the nation. The vast majority of individuals recognize the personal responsibility they take on in using a credit card. More than 96 percent of credit card holders pay their bills as agreed to and only 1 percent ever end up in bankruptcy. Bank credit cards represent less than 16 percent of total debt on the average bankruptcy petitions. According to a Federal Reserve Board survey last year, credit cards account for a mere 3.7 percent of consumer debt—hardly large enough to cause the bankruptcy crisis.

BANKRUPTCY REFORM ACT HAS IMPORTANT PRO-CONSUMER PROVISIONS

I am also pleased to mention that the Bankruptcy Reform Act includes a number of pro-consumer provisions. In order to provide debtors with the best possible information before they take the step of bankruptcy, the bill requires the distribution of information on bankruptcy and its alternatives to all potential filers. This is extremely important because in a study done in April of 1997 found that 50 percent of those individuals who filed for bankruptcy were not aware of their options besides bankruptcy. Of this group, 65 percent indicated they would have chosen financial counseling had they been aware of it as an option. Many people do not understand that repayment plans can often be worked out with creditors without having to file for bankruptcy. In addition, the bill provides for a test program through the U.S. Trustees office in which consumers who discharge their debts will have to attend a financial management training class. It is our hope that this class will teach consumers how to better handle their money and avoid bankruptcy in the future.

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Also the bill includes a unique *Debtor's Bill of Rights,* which outlines protection from so called "bankruptcy mills" for those who legitimately need a bankruptcy's safety net. Regrettably, there are some within the bankruptcy profession operating like a mill, steering many consumers into bankruptcy without adequately informing them of their choices and the potential harm that bankruptcy can have on their future financial records. The bill of rights would require any for-profit debt counseling agency to fully disclose the services they perform and the fee for this service up-front. The bill also provides for a full refund to the consumer if he or she is not represented fairly and adequately.

I believe that the *Debtor's Bill of Rights* and the consumer protection provisions provide the correct balance needed to restore our bankruptcy system to one of fairness and responsibility.

CONCLUSION

Many in Congress have already embraced the concept of needs-based bankruptcy reform. In fact, there are currently almost 170 co-sponsors from both sides of the aisle signed on to H.R. 2500 which has been encompassed in the consumer portions of H.R. 3150. This bi-partisan bill laid the foundation for the more expansive bankruptcy reform bill, the Bankruptcy Reform Act of 1998, introduced by this Committee's distinguished Chairman and myself, and the principle sponsors of H.R. 2500, Representatives McCollum and Boucher.

A reasonable needs-based formula permits a front-end determination, prior to filing, to ascertain under which Chapter a filer should proceed. This approach preserves the Chapter 7 fresh start for those debtors unable to repay their debts. Indeed, this front-end determination improves that fresh start by ensuring improper Chapter 7 filings are prevented from entering the system and clogging up the Chapter 7 process to the detriment of those Chapter 7 filers who genuinely need fast relief. The only "losers" in a needs-based approach are those individuals who have enjoyed the safety net of Chapter 7 despite their lack of need, and they, my colleagues, do not need our protection.

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I urge this Committee to expeditiously consider needs-based bankruptcy reform legislation and look forward to working with each and every one of you to accomplish this very important goal.

Thank you.

Mr. **GEKAS.** We thank the gentleman.

We now excuse our colleagues, with our gratitude, and expect them to stay in touch with us to proceed along the path of final passage. We thank them.

The record should indicate that we've also invited the gentleman from Michigan, Mr. Conyers, to join that panel, and we had not received an affirmation of that invitation as of this moment. But, we are told that he may join us at any time and, when he does, we'll accord him the opportunity to sit with the members.

Now, we'll turn to the first panel: The Honorable Edith Hollan Jones, Judge of the United States Court of Appeals for the Fifth Circuit in Texas; The Honorable Randall Newsome, U.S. Bankruptcy Judge, Northern District of California, and Lloyd N. Cutler, Esq., of Wilmer, Cutler & Pickering, who represents the Bankruptcy Issues Counsel.

We are pleased to have your testimony. We say at the outset that your written statements will become automatically a part of the record, without objection, and we will ask you very kindly to try to limit your oral presentation to 5 minutes. And, we'll give you some leeway, but we'll start pounding the gavel at some point.

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With that, we'll ask Judge Jones to begin the testimony.

STATEMENT OF HON. EDITH HOLLAN JONES, JUDGE, UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Judge **JONES.** Thank you, Congressman Gekas, and the other gentlemen here.

And I want to thank the co-sponsors of the predecessor bill to the Gekas bill for not taking the recommendations of the National Bankruptcy Review Commission seriously. I was a member of that Commission, as many in this room are aware. I was the person who dissented from most of its recommendations on consumer bankruptcy, which had no merit whatsoever, and I will not dwell on them further, except to note that the split within the Commission represented what, I believe, is a very unrepresentative split regarding the background and problems that we see today with consumer bankruptcy. I can't really improve upon the statements that Congressman McCollum, and Moran, and Boucher made about the abuse of our bankruptcy system today.

It is very difficult to ask me, as a former Commissioner, much less as a judge, to try to compress 2 years of my experience on the commission into a 5-minute presentation. But, I will endeavor to do so.

The Commission heard testimony from hundreds of witnesses. We received thousands of letters. They confirmed the impression that our bankruptcy system today lacks integrity, it lacks control. It is a system in which where everyone is nominally responsible for the integrity, no one is responsible. Most debtors never see a judge. Many bankruptcy lawyers never talk to their clients. The first time they see their clients often is when they are in a herd of people in the bankruptcy courts and the lawyers raises a hand and says, "Anyone who's my client needs to step forward right now." They do not oversee the integrity of the schedules. The lawyers are not bound by rule 11, as they are in every other Federal pleading, to verify the integrity of the schedules and the statements of affairs that the debtors have to present.

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Now, am I saying that every debtor is a louse and unworthy of relief? Of course not. Nor does H.R. 3150. What I am saying is that in the present system we have no way of verifying that the people who seek chapter 7 relief really need that relief.

The benefits of means testing seem to be manifest. First of all, we've got a novel problem in this country, in that we have 1.5 million filings—or that's the estimate for this year during unprecedented economic well being. This is completely novel. It demands a creative legislative solution.

Second, the means testing proposal builds on what already is means testing in chapter 13 of the Bankruptcy Code in the disposable income test. But, what it does is make that test uniform. It makes it predictable. It makes it administratively feasible because it is a test that the lawyer can apply, with his client, in their conference before the client files bankruptcy.

Finally, it is not inconsistent to have means testing in bankruptcy the same way, that we means test every other part of our social safety net in this society. Welfare, food stamps, social security, disability, medicaid—all are means tested. Bankruptcy is part of the social safety net. It ought to be means tested as well.

I support H.R. 3150. I want to make a final comment about the fact that you will hear from many representatives of the bankruptcy bar and the judiciary, and this is not personal against Judge Newsome in any way. You will hear great opposition, based on the fact that we judges will have to do much more work under this bill. I disagree with that. They haven't read the bill. They haven't applied the test. There will, of course, be a period of uncertainty as the kinks get worked out. But, generally speaking, its an objective test. It would provide a uniform test, which is something that our law sorely lacks now.

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Furthermore, the argument that these judges would have more work imposed on them is exactly the argument that my colleagues on the Article III bench complained about in sentencing guidelines. We have the guideline system. It has its flaws. But, it works fairly effectively.

Means testing is not anomalous to bankruptcy. In fact, it will ensure the integrity of our bankruptcy system. And, a final word on the data. No, we do not know all the data about bankruptcy. But, the studies that are coming out confirm that some people can repay some portion of their debt. Why in fairness should they not be required to do so? Nobody has successfully answered that question for me, and it seems to me that is the burden that the opponents of means testing must bear.

Thank you so much for your time.

[The prepared statement of Judge Jones follows:]

PREPARED STATEMENT OF HON. EDITH H. JONES, JUDGE, UNITED STATES COURTS OF APPEALS FOR THE FIFTH CIRCUIT

Thank you for inviting me to speak today on the need for reform of our nation's bankruptcy laws. It was an honor to serve at the request of Chief Justice Rehnquist on the National Bankruptcy Review Commission during our two-year tenure. The Commission offered me an unparalleled opportunity to consider questions that had bothered me ever since I practiced bankruptcy law, largely but not exclusively in business cases, for over five years before going on the bench.

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As you may know, the Commission split 5–4 on its most important recommendations, and I wrote several of the dissents. I am pleased to see that Congressmen Gekas, Moran, McCollum, Boucher and their many cosponsors saw through the fog created by the majority report and realized that there is a serious, immediate need for real bankruptcy reform. Consequently, unless you desire it, I will not dwell on the Commission's report but on insights I gained from the Commission's fact-gathering process that support the pending Bill, H.R. 3150, the Gekas-Moran Bankruptcy Reform Act of 1998.

I. CONSUMER BANKRUPTCY

The following remarks can be summarized in three propositions. First, bankruptcy has reached epidemic proportions in this country. Second, the bankruptcy reforms envisioned by H.R. 3150 will encourage bankruptcy as a last resort rather than a first resort for income-earning debtors, without hurting the truly deserving. Third, these bankruptcy reforms will especially help the poor and minorities by decreasing the cost and increasing the availability of credit.

A. The Need for Reform

Personal bankruptcy filings have reached epidemic proportions. In 1980, just after the Bankruptcy Code was passed and amid an economic recession, annual filings stood at slightly over 330,000. Last year, in 1997, following a sustained period of economic growth, the number of filings reached 1.3 million consumer bankruptcies. There has been a 60% increase in the last 5 years!

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We now confront an anomalous situation in which unemployment is falling but bankruptcy is rising. Opponents of reform have no response to the question—What will happen to our credit-driven economy when the next downturn occurs? Given present trends, and without reform, the personal bankruptcy filings can be expected to spiral out of control, dramatically affecting the availability of credit and aggravating economic problems.

None of the hundreds of experts and witnesses before the Commission could fully explain the bankruptcy epidemic. But no one suggests that the filings are any longer demographically confined to the lowest socioeconomic groups or those who have irrevocably lost their jobs or have become physically disabled. Seeking bankruptcy protection has become more and more common among fully employed middle- and upper-class people. More disturbingly, many debtors are now filing for bankruptcy protection *before* actually defaulting on debt. As Congressman Pete Sessions recently described it, bankruptcy is "for some people . . . just another tool of financial management."

Further, contrary to the inferences drawn by many bankruptcy practitioners and academics before the Commission, the rapid increase in filings cannot mean that the bankruptcy system requires amendment to soften its impact on debtors. If it were unfair to debtors, there would not be a vast migration toward bankruptcy when, as we see today, employment prospects seem brighter than ever.

In part, the bankruptcy boom springs from the intention of the 1978 Code. The drafters of the Code, some of whom still actively influence Congress, consciously sought to remove the social stigma from filing bankruptcy. The Code, for instance, replaced the term bankrupt with "debtor" and described a case filing as seeking an "order for relief." The Commission process confirmed the following facts. Filing bankruptcy is easy and relatively inexpensive. Most debtors never appear before a judge. Sanctions are rarely imposed for misuse of bankruptcy. Standards of debtor conduct are not enforced.

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Social and moral changes have also accelerated the trend to accepting bankruptcy as a feature of "normal" life. Movie stars, governors and "famed heart surgeons" have undergone bankruptcy to discharge their debts, so why shouldn't ordinary Americans? Gambling debts have caused dramatic increases in some jurisdictions. Bankruptcy is actively promoted in lawyer advertising and self-help literature. To take just two examples, a book titled *Debt Free!* offers "Your Guide to Personal Bankruptcy without Shame,"(see footnote 1) and my grocery store features a $16.99 guide to personal bankruptcy.

A prominent bankruptcy judge once commented to me that when he graduated from law school around 1950, there were two things that "people never did: divorce and bankruptcy." This comment captures an insight often overlooked by those who make their living from the bankruptcy process. Declaring bankruptcy has a moral dimension. To declare bankruptcy is to break one's contracts and agreements. Our society cannot function if it becomes widely acceptable to do this. In fact, the sanctity of contract—enforced by the rule of law—animated the growth, development and prosperity of the Western world. Enforceable contracts permit economic freedom to flourish and provide opportunity for all precisely because they are the product of voluntary action rather than state-sponsored preferences, priorities, or corruption. To regress from a norm in which contracts are enforceable threatens the foundation of our economic engine.

Beyond contracts and mere transactional effects are the distrust, disaffection and misunderstanding that erupt in a society which broadly permits such promise-breaking as occurs in bankruptcy. The large number of heartfelt and often poignant letters received by the Commission from creditors who were short-changed by debtors in bankruptcy attests to this sad reality. No doubt, bankruptcy is a necessary feature of Judeo-Christian capitalist societies, but to advance the equally moral goals of protecting social cohesion and general welfare, it cannot become more than an act of grace available to those who are truly and seriously needy. We must not, to paraphrase Senator Moynihan and former Treasury Secretary Lloyd Bentsen, "define bankruptcy deviancy downward."

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Finally, bankruptcy has a macroeconomic effect on the cost and availability of credit. Graphically demonstrating this impact are hundreds of letters the Commission has received from credit unions. Credits unions' losses in bankruptcy directly affect their loan rates and practices, and in the past three to four years, those losses have dramatically increased. Other lenders, large and small, have had similar experiences. The rising number of bankruptcies will increase interest rates for all consumers and will cause businesses to scrutinize credit more closely and discriminate among borrowers. The real losers as the supply of consumer credit tightens are those at the bottom of the ladder. Ultimately, a bankruptcy system that is too hospitable to debtors hurts bill-paying customers. It should be an obvious point that bankruptcy as a social welfare program is subsidized by creditors and, through them, by the vast majority of Americans who struggle and succeed to make ends meet financially.

B. Means-Testing

The time for means-testing access to bankruptcy relief has arrived. That is to say, debtors who are income earners and at least relatively well-off should be required to agree to repay some portion of their unsecured, non-priority debts in exchange for receiving a "fresh start" though discharge. These selected debtors should be channeled into Chapter 13 debt payment plans rather than being permitted to discharge all unsecured debts in Chapter 7.

Means-testing is not novel to bankruptcy. Moreover, to describe it as philosophically abhorrent to bankruptcy, as opponents do, is illogical and unrealistic.

Means-testing is not a novel concept because the Chapter 13 disposable income test already embodies a form of needs-based relief. The difference is that Chapter 13 isn't required for those who have the ability to pay, and it is unevenly applied throughout the country.

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Means-testing is not philosophically contrary to the bankruptcy system, properly viewed as a part of our social safety net. In every other government program that furthers social welfare—social security disability, food stamps, Medicaid, school lunches, etc.—benefits schedules and eligibility are means-tested to ensure that only those who really need help receive public largesse. In no social program other than bankruptcy is the beneficiary permitted to make a unilateral determination of the amount of relief desired.

Finally, means-testing is not inimical to bankruptcy relief simply because it hasn't been required before. Such hide-bound opposition overlooks present-day reality: the bankruptcy epidemic is also novel in our history. Dramatic problems demand creative solutions.

The issues in means-testing bankruptcy eligibility are simplicity, judicial and administrative feasibility, and fairness.

H.R. 3150 satisfies these standards. The bill measures income against fixed statistics for regional costs of living that are already in use by the IRS, social service agencies and some Chapter 13 trustees. The measures for income and expenses are objective, and eligibility for Chapter 7/13 relief can be easily determined in the debtor's first consultation with his lawyer. If the debtor and lawyer provide accurate information to the trustee, judicial intervention will rarely be necessary. Means-testing will not even apply to the majority of debtors whose income falls well below its threshold of approximately $38,000. Moreover, an "extraordinary circumstances" provision allows the court to determine when a debtor, although nominally in the higher income-earning range, experiences compelling need, such as a family illness, that mandates Chapter 7 relief.

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Other bills pending in Congress address means testing by modification of §707(b) of the Bankruptcy Code. Those bills would require a creditor to file a lawsuit, or adversary proceeding, against a debtor who the creditor thinks can repay a threshold amount of unsecured, nonpriority debt. This is a plausible alternative, as my dissent from the Commission report stated, but I do not think it preferable to the up-front, uniform test embodied in H.R. 3150. First, the §707(b) approach leaves it to each bankruptcy court to determine in each case what is an acceptable level of household expenses and repayment ability for a debtor. Non-uniform results are certainly more predictable here than through the up-front eligibility determination. Second, as this remedy proceeds through litigation, creditors will face a costly hurdle to proving a debtor's ability to repay. Some bankruptcy judges who commented to the Senate on a §707(b) modification endorsed it precisely because they foresaw few cases being brought under it. If this is correct, §707(b) will not be an effective remedy for bankruptcy abuse by those with an ability to repay.

The best way to defend the up-front eligibility test set out in H.R. 3150 is to address objections that have been raised to it. I will summarize these objections and my responses.

1. Means-testing will impose costs and burdens on the judiciary, trustees and attorneys. Response: First, there may be increased costs while the technical details of the law are worked out, but they should be minimized by the objective test used in H.R. 3150. Second, means-testing will be relevant for only about 20% of consumer debtors. Third, increased costs can be defrayed by higher filing fees or trustee fees. Fourth, any reform that curtails bankruptcy abuse will carry some initial costs.

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2. Means-testing is "unfair." Response: This is incorrect. Means-testing is a *progressive* reform in the sense that our tax system is progressive. The more you have the ability to repay, the more you ought to repay. It is not "unfair" to impose a price on higher income-earning debtors in exchange for the immense benefit of the automatic stay and fresh start discharge.

3. Means-testing "can't work" because debtors' schedules are unreliable. Response: This widely-voiced concern proves the need for reform! The objectors are admitting that the present system lacks effective oversight. If debtors are smart enough to "game" the system, they must be understating their assets and ability-to-repay.(see footnote 2) H.R. 3150 enhances the reliability of debtor's filings by requiring pay stubs, tax returns and other documents to be furnished timely to the trustee and by requiring random audits.

4. Using standard levels of expenses to measure debtors' ability to repay is unfair. Response: On the contrary, this bill incorporates standards already in use by government agencies. Dollar-indexed tax exemptions are also "unfair" geographically but perceived as necessary to achieve predictability and uniformity.

5. Means-testing does nothing to control bankruptcy fraud and may encourage it by giving debtors incentives to increase their expenses or secured debt. Response: I agree that means-testing does not reach certain forms of bankruptcy fraud and abuse. The Code addresses some of those abuses, and H.R. 3150 contains additional sanctions. Further, some debtors may misuse a means-testing system just as they do the present law, but that is not a reason to reject needed change, and H.R. 3150 contains provisions to discourage such misuse.

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6. Requiring some debtors to repay a portion of their unsecured debt violates the Thirteenth Amendment. Response: No court or serious scholar has accepted the argument on involuntary servitude.

7. Means-testing excludes other reforms. Response: Not at all, as H.R. 3150 shows. We still need reforms to enforce accuracy in debtors' schedules, limit repeat bankruptcies, and clarify rights of secured and unsecured creditors.

8. Chapter 13 doesn't work, because most debtors never complete their payments, and debtors in "forced" Chapter 13 cases will perform worse. Response: I disagree, because the higher income-earning debtors will not get a discharge if they do not complete their plans. Without a discharge, creditors will have incentives to pursue these well-off debtors.

9. "No one" in the bankruptcy system has a realistic ability to repay debt. Response: If this extraordinary blanket statement were true, then a means test, particularly the modest means test imposed by H.R. 3150, would have no adverse impact at all. It is contrary to human nature, however, to suppose that when the government offers a "free" discharge from debt, *no one* will take undue advantage of that system. The real question is how best to identify those who are taking advantage of bankruptcy and to make them pay for the privilege.

10. There are insufficient or unreliable data to support means-testing. Response: On the contrary, at least three recent studies have concluded, based on information available in debtors' actual bankruptcy filings, that a significant portion of debtors are able to repay some of their unsecured, non-priority debt. The last comparable study that might show otherwise was performed in 1981, well before recent dramatically increased filings. Many, many letters and articles received by the Commission emphasized that income-earning debtors are filing bankruptcy as a matter of convenience rather than dire necessity. As I see it, the empirical studies can't tell Congress exactly what means test to adopt, but they confirm these communications. Congress often legislates on principle, and many laws impose means-testing requirements as a matter of principle even though no precise data are available. At some level, means-testing is necessary and fair. The no data argument is a red herring.

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Means-testing is a modest attempt to restore even-handedness in the only social program our society now has which is guided entirely by debtor self-selection. The issue is like welfare reform, and the consequences are just as great.

C. Other Reforms

The Bankruptcy Commission members uniformly recognized the existence of particular forms of bankruptcy abuse not related to ability-to-repay. Three of those abuses are the widespread inaccuracy of debtors' schedules and statements of affairs, serial bankruptcy filings by individual debtors or groups of debtors, and excessive exemptions. We agreed on the need to study debtor education programs and encourage debtors' counsel to provide more adequate representation to their clients. The four dissenting Commissioners commented upon additional sources of problems, such as unclear provisions relating to secured creditors' rights, loading up on debt just before bankruptcy, and vague valuation standards for collateral.

H.R. 3150 responds to all of these concepts with provisions that strengthen and clarify the law. These changes will enhance the integrity of the bankruptcy system for debtors and creditors and, by clarifying the law, will reduce transaction costs in bankruptcy. All of these amendments stand fully independent of means-testing and should receive widespread support.

II. DIRECT APPEALS

The provision in H.R. 3150 for direct appeals of bankruptcy decisions to courts of appeals is also a valuable contribution to bankruptcy practice. Every group involved in the Commission's work, except the U.S. Justice Department, endorsed direct appeals. This measure is necessary to ensure uniform application of bankruptcy law.

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The current two-tiered scheme of appeals includes a stop at the district court. Bankruptcy law suffers from a lack of definite circuit-wide rulings because the parties cannot afford to appeal twice. This bill's direct appeal mechanism ameliorates any constitutional problem by modeling bankruptcy appeals after the provision for appeals from magistrate judge decisions. Finally, as a judge who has previously testified in the Senate on our appellate case load, I can state with some confidence that the increased number of bankruptcy appeals will not impose an undue burden on our courts. Civil appeals in the Fifth Circuit have decreased steadily for six years, and we anticipate a decline in prisoner section 1983 and habeas appeals following Congressional reform laws that are now taking effect.

III. BUSINESS PROVISIONS AND CLARIFICATIONS OF CONSUMER BANKRUPTCY LAW

In the interest of conserving time, I state my categorical support for the provisions of H.R. 3150 that would expedite small business bankruptcies and single-asset real estate cases, clarify parties' rights where the law is currently ambiguous, and streamline pre-packaged plans of reorganization.

Please do not be misled: these provisions are all workable, practical and in many cases they simply nationalize bankruptcy court and U.S. trustee practices in the most efficient jurisdictions. As we learned during the Commission process, much of the opposition to bankruptcy reform emanates from those with a vested interest in the system or whose ideology simply favors debtors. But these other provisions of H.R. 3150 are modest and fair measures that would reduce costs, delay and the geographic non-uniformity of current law.

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Mr. **GEKAS.** We thank you, Judge Jones, and turn to Judge Newsome for his testimony.

STATEMENT OF HON. RANDALL J. NEWSOME, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF CALIFORNIA

Judge **NEWSOME.** Mr. Chairman, members of the subcommittee, ladies and gentlemen, allow me to express my appreciation for the invitation to testify here today.

During my 5 minutes, I'd like to highlight a couple of points from the data I've collected. I hope you have a copy of it. It is a survey of 100 chapter 7 cases that I personally reviewed in Oakland, over the course of the last couple of months. It has a couple of typos. I've sent an errata sheet. I hope you can take a look at it at some point.

Mr. **GEKAS.** Yes, and we will include that as part of the record, unless it's already made a part of the record through your statement.

Judge **NEWSOME.** I don't know whether it's a part of the record or not, but I appreciate that, Mr. Chairman.

Mr. **GEKAS.** Well, we will make it so. Thank you.

Judge **NEWSOME.** Even for those of us who review bankruptcy schedules on a daily basis, the amount of credit card debt in these cases is shocking. It amounts to some 52 percent of all of the unsecured non-priority debt listed in the schedules. I am speaking here, solely, about all-purpose credit cards, such as Visa, Mastercard, American Express, and Discover—not lines of credit, not department store cards, not gasoline cards.

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The average household in these cases has unsecured credit card debt amounting to almost $25,000 per household. There may be many reasons why the debtors in the survey incurred so much credit card debt. I don't have time at this point to point to any specific cases.

You might want to take a look at case number 44 and case number 48. Case number 44 involved an Asian person, who does not speak English, who makes $600 a month on SSI and who had five credit cards and ran up a bill of $42,000 on them, probably to live.

The other case is 48. It involved a husband and wife, self-employed, who ran up $177,000 on 34 credit cards. Wouldn't you like to know what the people were thinking who issued the last 20 of those?

There may be many reasons, as I've indicated, why the debtors in the survey incurred so much credit card debt. Some of them understandable and, perhaps, even justifiable. Some of them not excusable, and, perhaps, not even lawful. Section 523(a)(2) of the Code, as presently written, is designed to root out those who have committed fraud in incurring debt. Judgments under the statute are handed down every day against debtors who are proven to have engaged in credit card fraud. No one could argue with the proposition that borrowers should borrow and use credit responsibly. Presumably, no one would argue with the proposition also that lenders should lend responsibly, pursuant to prudent lending practices. From the looks of these cases, Mr. Chairman, there is plenty of irresponsibility to go around.

These two cases may stand out more prominently than the other 98, but they certainly are not isolated instances in this 100 case survey, as I'm sure you'll see. Of all the numbers that have been thrown around in the debate over bankruptcy reform, the one I fear the most, but have not yet seen, is the estimate of the number of people in this country who are in the same financial shape as these 100 debtors, or not far from it, but who have not filed a bankruptcy. Perhaps I'm just an alarmist. My job tends to make you that way. But, the thought sends shivers down my spine.

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Now, you can change the bankruptcy laws to try to address this problem. You could even make all credit card debt non-dischargeable, which is pretty near what H.R. 3150 does, but it probably won't do anybody much good. You probably won't measurably improve the credit card companies' collections. Ask a few creditors' attorneys about their success rate in collecting on non-dischargeability judgments. They will tell you, almost uniformly, that they're usually not worth the paper they're written on—even after the debtor has discharged all of his other debts. The money's gone. The debtor is tapped out. There's just no more money to be had.

The only question is, what do we do now? If you, in essence, chain them to their indebtedness for life, you probably won't do the economy any good, and, who knows, you might even do it some harm. If the creditors hound them too much, they'll try to run and hide; they do. They will become financial desperados, in essence. In my view, the last thing we need in this country is millions of financially desperate people running around with no hope of relief.

Perhaps the credit card problem is solvable on the lender's end. Perhaps, if left alone, the free marketplace for consumer credit will correct itself through tougher lending standards and smaller extensions of credit. There is some indication that that correction is already underway—to the benefit of lenders, debtors, and the country as a whole.

My time is up. I would only respond—mention means testing in this sense. I have read the bill. I have attempted to apply the formula. It doesn't work very well. That is my opinion, with all due respect, Mr. Chairman.

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[The prepared statement of Judge Newsome follows:]

PREPARED STATEMENT OF HON. RANDALL J. NEWSOME, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF CALIFORNIA

Mr. Chairman and distinguished members of this subcommittee, I am honored to have been invited to testify before you regarding the important issue of bankruptcy reform. By way of background, I received a B.A. from Boston University in 1972, and a J.D. from the University of Cincinnati College of Law in 1975. I was appointed a United States Bankruptcy Judge for the Southern District of Ohio in Cincinnati on October 15, 1982, and was reappointed to a fourteen year term on that bench in 1986. I subsequently applied for and was appointed to my present position in 1988. I have sat as a visiting judge in the Western District of Washington, the District of Arizona, and the Central District of California. I have presided over cases ranging from the third largest chapter 11 case ever filed (Baldwin-United Corporation and over 200 of its subsidiaries) to the smallest chapter 7 and 13 filings, and virtually everything in between. It is no exaggeration to state that I have reviewed the schedules and statements of affairs of thousands of debtors over the last 15 years.

Let me preface my remarks by emphasizing that I appear before you representing only myself. Although my colleagues' views might be aligned with mine on numerous issues, it almost goes without saying that we wouldn't agree on everything. We never do. One thing I think we would agree on is that there are abuses occurring in the bankruptcy system. We see them all too frequently. No one is more concerned about them than we are, and no one works harder to stem them than we do. Regardless of my views on the bankruptcy legislation presently under consideration, I applaud your efforts to correct some of the problems in the present law.

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My goal in appearing here today is not to critique H.R. 3150. I am quite concerned about a number of issues, such as the potential overall cost of the bill, the virtual elimination of the chapter 13 super discharge, and the impact that this legislation will have on the bankruptcy courts' workload. I leave those subjects for others to address. In particular, I sincerely hope that Judge Robert Hershner, President of the National Conference of Bankruptcy Judges, will be given an opportunity to testify before you regarding the potentially significant increase in the courts' workload.

My intent here today is to make a small, but I believe important, contribution to the record of these hearings by presenting you with the results of a survey I personally conducted of 100 randomly-selected chapter 7 cases from the division in which I sit. One of the problems which plagued the National Bankruptcy Review Commission, and which continues to plague us today, is the lack of reliable, timely data upon which to make conclusions and propose reforms. The Commission took thousands and thousands of pages of testimony from dozens of witnesses, and received additional thousands of pages of position papers and other documents. At best, some of what was submitted could be termed an educated guess. At worst, some of what it received was self-serving conjecture and hyperbole. Particularly in the area of consumer bankruptcy, the Commission was frustrated in its efforts to carry out its assignment by the lack of reliable empirical research.

Unfortunately, this subcommittee is confronted with a similar lack of data. As I understand it, you are being asked to make decisions which may have profound effects upon the nation's economy and social fabric essentially based upon one empirical study, that being "Personal Bankruptcy: A Report on Petitioner' Ability-to-Pay" by Barren and Staten. While certainly a good first step, this study was funded by the credit industry, a group which would not meet the disinterestedness test, to use bankruptcy parlance. You are entitled to, and should insist upon, raw data from disinterested sources from which you may draw your own conclusions regarding the state of the bankruptcy system. Hopefully, the survey data I have presented to you today will be viewed as a first, but by no means the final, step towards filling the empirical void.

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My methodology for conducting this survey is set forth in a separate document attached to the data reports, and will not be repeated here. The cases which the Oakland clerk's office pulled were filed over nineteen separate months between January 1, 1996 and September 30, 1997. The debtors who filed those cases come from thirty different cities in Alameda and Contra Costa counties, which comprise the area served by the Oakland Division. Some 65 of the cases were filed as voluntary cases by individuals under 11 U.S.C. §301, and the rest were filed as husband-and-wife petitions under §302.

The debtors in this survey are not a picture of prosperity. According to the Bureau of the Census, the median income for California as a whole in 1995 was 38,780. The press of time prevented me from obtaining the median income figure for the relevant counties, but suffice it to say that the Bay Area of California has one of the highest cost-of-living figures in the country. The average gross income from all sources for the 100 households in this study is about $32,800. Of the 36 households who have children residing therein, the average income from all sources is approximately $48,611. Forty-eight households were earning less than $30,000 per year as of the date of filing. Six households receive all or some of their income from pensions or Social Security. Seven people were reported as disabled. Ten people were reported as unemployed, and a few held only temporary jobs. Fifty-eight households were renters, and paid average rent of $614. Thirty-three were homeowners, and their total average mortgages were about $171,142.(see footnote 3)

The nature of the motor vehicles owned by these debtors reinforces the view that by and large, they are not living luxurious lifestyles. The average model year for the 129 vehicles listed in the debtors' schedules is about 1987. By my count, only 43 have secured vehicle debt. The rest are making do with older cars. Given the legendary length of commutes to work in the Bay Area, most debtors are probably spending an excessive amount of their income just keeping their cars in running order.

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One of the most striking figures in this data is the amount of credit card debt owed. As the explanatory notes to the data indicate, this calculation does not include anything other than all-purpose credit cards such as Visa, MasterCard, American Express and Discover. When in doubt, I excluded debts that I was uncertain represented credit card indebtedness. Lines of credit were also excluded. Even using a conservative approach, credit card debt constituted fully 52% of the total unsecured nonpriority debt listed. The average amount of credit card debt per household was a staggering $24,800.(see footnote 4) The average number of such credit cards held by debtors was about 6. By comparison, retail store and gasoline card debt averaged only $526, and the number of such cards held by debtors was less than three. Assuming that the primary objective in filing a chapter 7 case is to obtain relief from unsecured indebtedness, it is fair to state that credit card debt in the overwhelming majority of these cases was not merely a factor in the debtors' decision to file, it was the prime, and indeed in many cases, the sole reason for filing.

After compiling the data you have before you, I attempted to apply the proposed means testing formula in H.R. 3150 to a sample of the cases I reviewed. I encountered significant problems in doing so, and a few unpleasant surprises in the results. Section 101 sets forth a new subpart (h) to §109 which essentially sorts out those who may file under chapter 7 and those who must file under chapter 13. If a debtor has more than 75% of the "national median family income for a family of equal size," has more than $50 in "projected monthly net income", and has sufficient projected monthly net income to pay at least 20% of her unsecured nonpriority debt, then she may not file a chapter 7 case. New §101(40A) defines national median family income to be the Census Bureau figures as of January 1 of the previous calender year. I will assume that those figures exist, but I was unable to find them.

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The crux of the means test is in the definition of projected monthly net income. This figure is arrived at by subtracting the following from the "currently monthly net income" as defined in §101(10A):(see footnote 5)

(1) "the expense allowances under the applicable National Standards, Local Standards and other Necessary Expenses allowance . . . in the area in which the debtor resides" promulgated by the Internal Revenue Service;

(2) average monthly payments to secured creditors;

(3) average monthly payments to priority creditors;

(4) such other expenses as the debtor establishes are justified by extraordinary circumstances.

I instructed my law clerk to contact the IRS to obtain a copy of the National Standards. However, our local IRS office apparently has never heard of them. We then obtained over the Internet what appear to be the publications described in the statute. They consist of collection financial standards "to help determine a delinquent taxpayer's ability to pay a delinquent tax liability." There are National Standards for food, clothing and other items; National Standards for the monthly cost of purchasing an automobile, and Local Standards for operating costs and public transportation; and Local Standards for housing and utilities.

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If in fact these are the standards the statute is referring to, I believe they are fatally flawed and demonstrably unfair. For example, refer to case 15. This is a family of four with two children, ages 5 and 3 living in the upper-middle class suburb of Danville. The father is the sole provider, and the family's gross monthly income is $7,740. The monthly mortgage on the family home is $2,145, which does include taxes, but does not include insurance. Homeowner insurance in the Bay Area, even without earthquake coverage, is very expensive. The local standards for housing expense also include utilities, but do not break these expenses out. Actual mortgage payments are deductible under the formula, but utilities are not provided for. It is entirely unclear whether they can be deducted, and in what amount, if the debtor is a homeowner.

The debtors' only other secured debt payments amount to $570 per month on two cars (one of which he intends to surrender). His payroll taxes are $2,322. The IRS local standards for automobile operating costs on two cars is $373. I was unable to determine what this number includes, but it would barely cover gas, tolls and parking in the Bay Area, all of which are inordinately expensive. Automobile insurance alone would consume most of this amount.

In addition to their mortgage, car and tax payments, the debtors would be entitled to a deduction under the formula for "food, clothing and other items." The National Standard for a family of four within the debtors' income range is $ 1424. Again, the standards are silent as to how this number was arrived at and what is included.

The mathematical calculation for determining chapter 7 eligibility for the debtors would be as follows:

$7,740—Gross Income

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– 2,145—Mortgage
– 570—Car payments
– 2,322—Payroll taxes
– 373—Auto operating allowance
– 1,424—Food, etc. allowance

+ 906.

There may be other taxes that the debtor could deduct, but they probably would not amount to more than $200 per month, and utilities have not been factored in because the IRS allowance for them cannot be determined. Assuming the net current monthly income with a deduction for utilities is $600, debtors clearly are not qualified for chapter 7 relief, since they could pay at least 20% of their almost $60,000 in unsecured debt over 60 months as well as all of their small priority tax debt.

What about the fact that the debtors calculate gas and electric, water, telephone, cable and garbage at $422 per month? The telephone bill at $146 per month may be high, but the rest of the utilities look appropriate. Should the trustee have them bring in a year's worth of telephone bills to establish extraordinary circumstances? How about the $250 in medical expenses the debtors claim in Schedule J, or $119 in recreation, or $100 for home maintenance, or $191 for homeowners insurance, or $95 in life insurance, or $164 in automobile insurance? Shall we effectively prohibit the debtors from making charitable contributions? Some church denominations require tithing of up to 10% of their members' gross income. There appears to be no room in this formula for that sort of contribution. Where does health insurance fit into the formula? Must the debtors simply forego having any for 5 years? What about 401(k) and other pension contributions? They're taken out of payroll, but the formula does not allow them as a deduction. The same holds true for union dues. What about child care? Neither the IRS nor the formula addresses this major expense for young working families. What about tuition and other expenses of parochial or other private schools? What about assistance with a child's college education? To what extent are we to intrude into the debtors' privacy as the cost of eligibility for chapter 7 relief? It does not require extended examination to determine that the IRS standards are woefully inadequate for the task they've been assigned.

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Assume that on the same day that the chapter 7 trustee shows case number 15 to the chapter 13 door, case number 48 is also heard. This case involves a husband and wife with three children ranging in ages from 5 to 19. The debtors are both self-employed, and their businesses generate combined income of $13,935 per month. Their business expenses are claimed as $7,856 per month. Are these deductible under the formula? The statute doesn't say. Assuming they are, their total gross income per month is about $6,079. They lease a 1991 Mercedes 420SEL and are purchasing a 1990 BMW 525i. The statute only allows deductions for secured obligations. It says nothing about car leases, which typically are a hybrid of secured and unsecured obligations. Assuming that the Mercedes lease can slip under the definition of secured, the debtors would be entitled to deduct all of their $916 car payments per month. Their mortgage is $1960 per month, real estate taxes are $250, and their income taxes are $2,000. Add as deductions under the IRS guidelines $1,619 for food, etc. and $373 for auto operating expenses, as well as $300 for utilities (even though the guidelines don't say we can), and you come up with minus $1,339 in current monthly net income. Even if their expenses could be pared by the trustee to show a positive $1,000 per month cash flow, they could still choose chapter 7. They have $44,766 in priority income taxes which must be paid in full. They also have $210,720 in unsecured nonpriority debt,(see footnote 6) over $177,000 of which is credit card debt. Obviously, they will fall far short of the 20% threshold, even if $1,000 per month is paid into the plan.

How do we explain to the debtors in case number 15 why the debtors in case number 48 are entitled to chapter 7 relief, but they aren't? Indeed, how do we explain that to the debtor in case number 31? She is a single mother who is a teacher in the Oakland school system. She must commute about 25 miles each way from her home in Antioch to work. She lists as her only vehicle a 1979 Volvo with 160,000 miles. She lists an 18-year old son as her only dependent. Her expenses include $400 per month for college tuition and books. Her gross income is $4,399 per month. Her deductions under the means testing formula would be as follows: her mortgage is $1,451 including taxes (which are deductible) and insurance (the deductibility of which is not clear). She lists no other secured debts. Her payroll taxes are $955 per month. She is only entitled to an automobile operating allowance under the IRS standards, since she has no car payment. That allowance for one car is $320. Assuming another $300 for utilities is allowable (again, unclear) and with the IRS food, etc. allowance of $927 for a family of two, her projected monthly net income is $746. Sixty months times this amount is $44,760. She easily meets the 20% threshold, and thus is not eligible under chapter 7, since she owes no taxes or other priority debt, and her nonpriority unsecured debt is only $25,556.

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With the raw data before you, the committee can do its own means testing calculations as to any of these 100 cases.(see footnote 7) What you may find, among other things, are the following:

(1) Under this proposal, homeowners may be penalized and renters may benefit. That is because the IRS standards will more easily cover the rent and utilities of a renter than a property owner.

(2) The more debt that is incurred prior to filing, the more likely the debtor will qualify for chapter 7. Perverse as it may seem, I can envision debtor's counsel advising their clients to buy the most expensive car that someone will sell them, and sign on to the biggest payment they can afford (at least until the bankruptcy is filed) as a way of increasing their deductions under §109(h). The tax game of maximizing deductions will become a way of life in bankruptcy court.

(3) People's circumstances and problems do not fit easily into a matrix. Means testing will discriminate unfairly among those who are similarly situated.

In conclusion, I urge this distinguished subcommittee to go forward with legislation that will provide data on the reasons for the steadily-rising numbers of consumer bankruptcies, to pursue some sort of auditing process for consumer cases which is adequately funded, and to pass the chapter 11 amendments that are contained in H.R. 3150. Action on the consumer amendments should be deferred until sufficient data has been gathered and analyzed by an independent, disinterested party. Thank you again for giving me this opportunity to be heard.

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Mr. **GEKAS.** We thank the gentleman.

And, now we turn to Mr. Cutler. By the way, Mr. Cutler, in your resume, why isn't there mention of frequent appearances on "Nightline" or "Meet the Press?" I didn't see such a notation.

STATEMENT OF LLOYD N. CUTLER, ESQ., WILMER, CUTLER AND PICKERING, REPRESENTING THE BANKRUPTCY ISSUES COUNCIL

Mr. **CUTLER.** I was trying to keep away from those as much as I can. [Laughter.]

I'm appearing here today—I hope it's not on C–SPAN—[Laughter.]—on behalf of the Bankruptcy Issues Council, which represents the 6,000 members of Visa and Mastercard, to discuss one of the most significant issues facing our judicial system today: the flood of personal bankruptcy cases that, as the chairman noted, has reached more than 1.3 million cases in the last year, an increase over the previous year, well over 20 percent. And, I believe that our court system cannot handle a caseload of that size with fairness and efficiency. I also believe it's critical to our form of government that our courts are perceived to be fair, and that our laws are applied equally to all people.

As the members of this panel know very well, our courts are a relatively inefficient forum in which to resolve most commercial disputes, especially small ones. Litigation is expensive and time-consuming. The costs of litigation quickly overwhelm the parties, even in multimillion dollar cases, involving large business. And, of course, that's even more true when the dispute involves the relatively small amounts at issue in most personal bankruptcy cases.

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In order to handle these disputes involving relatively small amounts, I agree with Judge Jones that the Congress needs to establish clear and objective tests that can be understood by ordinary citizens outside the judicial system, so that people will know how these tests apply to them before they file a bankruptcy case. As you are aware, under current law, an individual can file under chapter 7, and, unless a particular debt is found non-dischargeable by the court, that individual will receive a discharge of virtually all debts, irrespective of that individual's ability to pay at least a part of what he owes.

A debtor who has a job and a steady income is still entitled to obtain a discharge, even if that individual has the capacity to repay some of his debts. On the other hand, under chapter 13, the debtor would have to enter into a repayment plan, and make some payments to his creditors over a 3-to-5-year period.

The great virtue of the bill introduced by you, Mr. Chairman, and Mr. Moran, and others, is to establish clear, numerical tests that would screen out those people who, absent a showing of extraordinary need, should be filing under chapter 13, rather than under chapter 7. And, I understand there's been some concern on the committee about the use of objective tests, and my panel member on the right seems to share that opinion. But, those tests—especially when they allow for an exception in extraordinary circumstances of hardship—are in fact much fairer, and certainly more efficient than relying on our courts to decide on a case-by-case basis, what is so-called "abusive conduct."

We already have such tests in the bankruptcy law. The Federal exemptions which determine how much property a debtor may retain in a chapter 7 case, have explicit dollar levels, and, although, there can be disputes about how to value any of that property, as I understand it, it's very rare that the courts have to become involved in doing so. And, we employ objective tests, like this, in many other areas of our law: qualification for the earned income credit, federally-insured student loans, food stamps, welfare, medicaid. Eligibility all depends on numerical tests that can readily be applied outside of a court room. And, it seems to me that allowing a discharge of all your debts when you can afford to pay some of them is certainly a government grant of the same caliber, the examples I've just mentioned. It would be consistent to establish numerical tests just as we do in all these other areas.

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We have to balance a set of conflicting goals. We have to balance between those who are forced to file for bankruptcy, and those who are struggling to pay their bills, but are not seeking bankruptcy relief. Now, a discharge for those who have no ability to pay their debts is one thing, and that is certainly necessary, but we have to be fair to those who extend credit, and to the vast majority who are paying their bills. And, we have to do it in a way that doesn't lead to endless litigation about who qualifies for different chapters of the bankruptcy code, And, legislation, such as that which you have proposed, Mr. Chairman, it seems to me to be a fair resolution of those principles. Thank you.

[The prepared statement of Mr. Cutler follows:]

PREPARED STATEMENT OF LLOYD N. CUTLER, ESQ., WILMER, CUTLER AND PICKERING, REPRESENTING THE BANKRUPTCY ISSUES COUNCIL

Mr. Chairman, it is an honor to appear before this Subcommittee to address one of the most significant issues facing our federal judicial system today—the flood of personal bankruptcy cases that reached more than 1.3 million cases last year. I am appearing here today on behalf of the Bankruptcy Issues Council, which represents the 6,000 members of Visa and MasterCard.

Although it is long since I practiced bankruptcy law—I did co-author a well-known article with Professor Eugene Rostow on the original Chapter XI—I do believe that our court system cannot handle with fairness and efficiency a caseload of that size. I also believe that it is critical to our form of government that our courts are perceived to be fair and that our laws are applied equally to all people.

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I have reviewed some of the material that has been prepared by the opposing sides on the debate about needs-based bankruptcy. It has long been my view that our courts are an inefficient forum in which to resolve commercial disputes. Litigation is expensive and time consuming. The costs of litigation quickly overwhelm parties in multi-million dollar cases involving large businesses. This is even more true when the dispute involves the relatively small amounts at issue in most personal bankruptcy cases. In order to handle disputes involving relatively small amounts, the Congress must establish clear and objective tests that can be understood by ordinary citizens outside the judicial system so that people can know how the tests will apply to them before they file a bankruptcy case.

I understand that the bill sponsored by Congressmen Gekas, Moran and others has a series of tests for determining whether an individual filing for bankruptcy relief will be eligible to file under Chapter 7 or will be required, absent a showing of extraordinary need, to file under Chapter 13. As you are aware, under current law an individual can file under Chapter 7, and unless a particular debt is found nondischargeable by the court, that individual will receive a discharge of virtually all debts, irrespective of the debtor's personal financial situation. That is, a debtor who has a job and a steady income is entitled to obtain a discharge even if that individual has the capacity to repay some portion of the debts owed to his creditors. Under Chapter 13, on the other hand, the debtor enters into a repayment plan and makes some payments to his creditors over a three or five year period.

The bill introduced by Congressmen Gekas and Moran would have certain clear tests to screen out those people who would, absent a showing of extraordinary need, have to file under Chapter 13. The tests would not apply to anyone whose income was below 75% of national median income, so it would not apply at all to our poorest citizens. It would also only apply to those people who have the capacity to make payments of at least $50 per month to their creditors after allowing for basic family necessities.

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I understand that there has been some concern about use of such objective tests. In my opinion such tests, with allowance for showing extraordinary circumstances, are in fact much fairer, and certainly more efficient, than relying on our courts to decide on a case-by-case basis what is abusive conduct. I note that, for example, under the current bankruptcy laws, the federal exemptions—which determine how much property a debtor may retain in a Chapter 7 case—have explicit dollar levels such as $15,000 in value in a residence, $8,000 in personal property, and $1,500 in tools of trade. *See* 11 U.S.C. sec. 522. Although there can be disputes about how to value any of that property, I am informed that it is rare that the courts have to become involved in doing so. We also employ objective tests in many other areas of our laws, such as qualification for the earned income credit or for federally insured student loans. Use of similar objective tests to determine whether an individual is entitled to the extraordinary relief of a discharge of all his or her debts appears to me to be consistent with how our laws apply in many other areas.

There is a need, when we are faced with more than 1.3 million new cases each year, to balance a set of conflicting goals. Our laws must be perceived as fair both by those who are forced to file for bankruptcy and by those who are struggling to pay their bills but are not seeking bankruptcy relief. I certainly appreciate the merit of a complete discharge for those who have no ability to repay even a part of their debts. But we must be fair to those who extend credit and to the vast majority who are paying their bills, and not endorse a system where bankruptcy is perceived as an easy way out without paying even what one can afford to pay. And we have to do that in a way that does not lead to endless litigation about who qualifies for different chapters of the Bankruptcy Code. Legislation that excludes from its application our poorest citizens, establishes a few objective, bright line tests to determine basic ability to repay, and only requires rare case-by-case judicial intervention would appear to be to be a fair resolution of those principles.

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Mr. **GEKAS.** We thank the gentleman.

The Chair wishes to acknowledge the attendance of the lady from Texas, Ms. Jackson Lee, member of the subcommittee, and the ranking member of the full committee, the gentleman from Michigan, Mr. Conyers.

And, the Chair will yield itself the customary 5 minutes, and then allow each member, to examine the witnesses.

The first question that I have is for Judge Newsome. Did you say that 52 percent of the debt is creditable to the credit industry?

Judge **NEWSOME.** Yes, sir.

Mr. **GEKAS.** Thank you.

Judge **NEWSOME.** I want to emphasize, however, I was very conservative in counting that debt. If I wasn't fairly confident that the debt was a credit card debt, in other words, a Visa, a Master charge, or American Express, something like that, then I didn't include it. I included it in another category.

Mr. **GEKAS.** Then, the other 48 percent, what does that include? Does that include——

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Judge **NEWSOME.** Gasoline and retail charges. It includes all sorts of other kinds of unsecured debts.

Mr. **GEKAS.** Yes. And, so that, half of the debt under your statistics is not attributable to the excesses of the credit card industry, is it?

Judge **NEWSOME.** Actually, when you take out the $177,000 case, it's more like 57 percent, but you would be correct, yes, sir. As far as I can tell.

Mr. **GEKAS.** So, even if we don't cure the ills of the credit card portion of the stigma that has hit the bankruptcy area, we still would be addressing about half of it in a needs-based objective testing, where the mom and pop grocery store, which has to suck up $100 work of goods that somebody has gone bankrupt, and now is discharged. Or the gas station, or the credit union debts, or others, that are not included in credit cards. That's the picture that I want to try to portray if you can agree with that.

Judge **NEWSOME.** Well, I certainly can't argue with that, Mr. Chairman, except to say that mom and pop probably would have gotten paid had it not been for the credit card debt because mom and pop don't usually charge 18 percent on their accounts.

Mr. **GEKAS.** But, if mom and pop aren't paid, do they have a chance of retrieving that $100? Is that important to them?

Judge **NEWSOME.** It most certainly is——

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Mr. **GEKAS.** Yes.

Judge **NEWSOME** [continuing]. It would be to me.

Mr. **GEKAS.** And, if we don't have these objective tests, how would we know whether that $100 would be important to the debtor and to the credit offeror.

Judge **NEWSOME.** Mr. Chairman, I—I am not here to argue with you about the good or bad of means testing.

Mr. **GEKAS.** Yes.

Judge **NEWSOME.** There are some other things that could happen, such as changing 707(b) to take the substantial out of substantial abuse, and then listing a set of criteria by which the court may judge whether or not a particular case is, in fact, abusive of the system. I just don't agree, and I've tried, I really labored mightily, Sunday night and Saturday night—I just got this invitation on Friday. I've labored mightily to try to apply your means test, Mr. Chairman, and I just can't do it. You'd be surprised if you'd read my testimony and take a look at these cases, at the very strange results that you'd get.

Mr. **GEKAS.** Well, we invite you to apply the test to the statistical data that you've already compiled, and to submit a memo to us, and we'll include that in the record, and even invite you back to testify as an alternate witness to the list of witnesses that we'll put in at the end of the process.

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Judge **NEWSOME.** I would——

Mr. **GEKAS.** Mr. Cutler says that the very thing that you say can be cured by the abuse sections of the Bankruptcy Code leaves too much discretion to the judge alone. At least the discretion in 50 states is so proportionately disparate that perhaps an objective starts everybody at the same yard line.

Judge **NEWSOME.** Why not, as a part of the objective test, change 707(b) and say that one of the things that the court must look at is the level of income of the debtor in determining whether or not there has been an abuse of the system? That's something than can be done, and court's know how to do that sort of thing.

Mr. **GEKAS.** Why isn't it done now, and, if it has been done—which we think it has, Judge Newsome—then, how did the 1,300,000 bankruptcies occur.

Judge **NEWSOME.** It is done, Mr. Chairman. When there's a motion brought by the U.S. trustee, or when we bring it on our own motion, but those motions are not brought very often because the test is substantial abuse.

Mr. **GEKAS.** And, that's exactly the point. If the trustees don't bring on their own motion, then maybe we should have a starting point where we get to a point that the test can be made.

Judge **NEWSOME.** I have a feeling we would have a lot of such motions——

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Mr. **GEKAS.** We may.

Judge **NEWSOME** [continuing]. If the creditors were entitled to bring them and that might solve the problem.

Mr. **GEKAS.** We may, and I say, maybe we have to do something.

The time of the Chair has expired. The gentleman from New York, Mr. Nadler, is recognized for 5 minutes.

Mr. **NADLER.** Okay, thank you. I have a number of questions for Judge Newsome.

Following up on the chairman's question, it is your testimony that the reason you don't have a lot more 707(b) motions from the court itself, or the U.S. trustee, is because, in many cases, they feel that they couldn't meet the test of substantial abuse, and that if we said, in the bill, abuse rather than substantial abuse, and defined it, you'd get a lot more such motions.

Judge **NEWSOME.** Yes, sir.

Mr. **NADLER.** And, you think that that would go a long way to solving whatever problems there are?

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Judge **NEWSOME.** Yes, sir, I do.

Mr. **NADLER.** Thank you. Let me ask you a different question. If we allowed parties in interest to bring 707(b) motions, there would obviously be a lot more such motions. Do you think that that would lead to coerced reaffirmation agreements to the prejudice of other creditors?

Judge **NEWSOME.** I think it might. But, I think that's a separate abuse that I think the courts can deal with. If you ask me how, I guess I'd have to hedge at this point. But, I think, frankly, we've already shown an ability to deal with abusive reaffirmation situations as recent history shows.

Mr. **NADLER.** Do you think if we allowed parties at interest to make such motions, it would lead to a lot of motions that debtors would not have the legal wherewithal, the financial resources to combat properly?

Judge **NEWSOME.** I think that that's a danger, yes. But don't forget that Rule 9011, which is the counterpart to Rule 11 of the Federal Rules of Civil Procedure, would apply in those hearings.

Mr. **NADLER.** Do you think that's sufficient? I mean, with all due respect, anyone who knows what's going on knows that large corporations follow strategies of wearing down small litigants every day in Federal courts and the state courts, despite Rule 11. Would you agree with that?

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Judge **NEWSOME.** Yes, sir, that's true.

Mr. **NADLER.** So Rule 11 is not a solution to that problem, at least not a comprehensive solution?

Judge **NEWSOME.** That's true.

Mr. **NADLER.** Now let me ask you this: Under chapter 13, currently 64 percent of debtors who file reorganization plans, those plans fail 64 percent of the time. What would happen, do you think, if we forced a lot more people to chapter 13 rather than chapter 7? Would more plans fail? Are we just fooling ourselves with this proposal?

Judge **NEWSOME.** Well, I think the answer to that is unquestionably yes. As a matter of fact, I reviewed 50 chapter 13 cases before I reviewed these 100 chapter 7 cases, and I decided that the data was meaningless because so many of the cases were dismissed before they even got to the first meeting, let alone before they got to confirmation and after confirmation. Out of 50 random selections by my clerk's office, I think I only had one or two where they actually had completed the plan.

The answer to the question, the short answer, is absolutely yes. I think that if we start showing people to the chapter 13 door under the test that's being proposed, we're just going to have a lot of failed plans, and then they'll be in even worse shape under this bill, because they will have already filed one bankruptcy, and they will have to show a great deal more, if they file another.

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Mr. **NADLER.** And do you think that the bill before us, the Gekas bill, would raise the cost of bankruptcy proceedings?

Judge **NEWSOME.** I don't think there's any question about that.

Mr. **NADLER.** How would it do that?

Judge **NEWSOME.** Well, in a number of different ways. For one thing, every time there's a mention of extraordinary circumstances, for example, in this bill, the debtor having to establish extraordinary circumstances, it's a litigation point. It would mean that—and not only that, but to go back and review a plan or the debtor's financial circumstance in chapter 13 each and every year, mandatory review each and every year, is bound to, frankly, mire the bankruptcy court into basically a continued first meeting, like under the old Bankruptcy Act.

Mr. **NADLER.** So you would say we need a lot more judges if this bill passed?

Judge **NEWSOME.** I think we will.

Mr. **NADLER.** And the current law does provide for throwing a debtor out of chapter 7 if he has the ability to repay his debts, correct?

Judge **NEWSOME.** That's correct.

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Mr. **NADLER.** And how do the courts consider income in that test now?

Judge **NEWSOME.** Well, there is no specific criteria in 707(b) right now. You look at what their expenses are. Are the expenses inflated? We have their schedules I and J that we can rely upon, and in the hearings I've had, the few hearings I've had under 707(b), you look at their expenses; you look at their income; you take testimony; you try to determine whether or not the expenses are valid and whether or not they disclosed all their income. And if it turns out that they've got a substantial amount, maybe $100, $200, $300 above their expenses at the end of the month, that might be enough to put the case into chapter 13.

More often than not, because we are not dealing with people that are financially sophisticated here, they have understated many of their expenses. The fact is that, to a certain extent, I think these schedules are probably filled out based upon the last bill the debtor paid. Most of these people don't have $100 phone bills every month, I don't think, and yet that's probably the last bill they paid because they were two or three months behind. So they figure it's $100; that's what my telephone expense is.

I don't know whether I've made myself clear on that point, but I do think, and I am sure, that there's a tremendous amount of financial unsophistication among this body of people.

Mr. **NADLER.** Mr. Chairman, I ask for unanimous consent for 1 additional minute. I have one more question.

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Mr. **GEKAS.** Fine.

Mr. **NADLER.** Thank you.

Judge Newsome, you have testified that you think it's a good idea to have a better test through applying section 707(b) more stringently, getting rid of the substantial abuse, making abuse the finding, and so forth. If that is the case, what is wrong with having a more precise test, such as the bill provides, a precise formula test, one that we can put into the computer and get an answer from? I mean, what's wrong with that?

Judge **NEWSOME.** What's wrong with that is that people's circumstances—as I state in my testimony, my written statement, people's circumstances and problems don't fit very easily into a template or matrix or a means test, for that matter.

For example, means testing, as it's now proposed, doesn't account for one penny of child care, day care, for example. Where does day care fit into this test? It doesn't. Where does medical insurance or life insurance? Where do the debtors' 401(k) plans—are we not going to have debtors be allowed for 5 years to devote anything to their retirement? They may end up—they may pay back their debts, but they may end up as wards of the State at the end of the day. There's nothing in this bill for any of that.

Frankly, I don't know that the bill could be encompassing enough to take into consideration all of the circumstances we see among a very troubled group of people.

Mr. **NADLER.** Thank you, sir.

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Mr. **GEKAS.** To parallel the gentleman from New York, the Chair will yield itself 1 minute to ask Judge Jones to comment on the unworkability of the objective test, as has been referred to by Judge Newsome.

Judge **JONES.** I think the point of the test is plainly to have a set of standards that the lawyer can apply to his client in the office, and it clearly says that. The idea that this will impose a greater burden on the courts I do not buy because, first of all, this only applies to debtors, possibly the top 20 percent of debtors, those who make $38,000 a year and up. And what about the doctors? And what about the real estate investors who have gone bad? Shouldn't they, if they continue to be income-earning, still have to pay something? The objection does not meet that problem.

The objection is made that chapter 13 doesn't work now, and it won't work if it's compelled. I disagree, because you're dealing with the better-off debtors in this means-testing program, which is to say, they have the most to lose if they complete their payment plans and don't get a discharge.

As far as the survey of all 100 petitions goes, Ernst and Young did 9,000 petitions. Dr. Staten did 3,000 petitions. Now you may say, oh, those are just the nasty credit card industry. I'd like somebody to talk about the facts that are revealed in those statements, and not just slur them as to who may have provided the funding. Data are data. They're either accurate or they're not. If a certain percentage—and these studies reflect 10 to 15 percent—can afford to pay, why shouldn't that limited group of debtors pay the price, the same as you and I pay a price in higher Federal income taxes because we're the privileged members of society? Why shouldn't the privileged members of society who borrowed beyond their ability to pay have to have a little cost attached to securing the immense benefits of bankruptcy that are built on the backs—on the backs—of the hard-working poor and the minorities, because it is not the minorities who are filing bankruptcy today, for all practical purposes?

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And one final—this may be nonresponsive—one final, brief point in regard to the viability of a 707(b) test: I address that in my dissent from the Commission report. I think it is certainly worthwhile, and possible to reform 707(b), as even Congressman Nadler now suggests and Judge Newsome does. I have two objections to that relative to H.R. 3150, though I do not oppose it generally.

One is the results will necessarily be nonuniform, because every bankruptcy judge will reach a facts-specific determination of what is, quote, "abuse." The second is that that remedy is only actuated by litigation. Litigation costs a great deal of money in bankruptcy relative to the returns, and therefore, it is a somewhat less effective mode of proceeding.

Mr. **GEKAS.** The time of the Chair has expired. The gentleman from Massachusetts is recognized for 5 minutes.

Mr. **DELAHUNT.** I'm going to defer for the moment to Ms. Lee.

Mr. **GEKAS.** Well, then, we'll change the order and we'll recognize the lady from Texas for 5 minutes.

Ms. **JACKSON LEE.** I thank the chairman very much, and I do thank the witnesses for their appearance, even at this short notice.

I'd like to associate myself with remarks of my colleague, Mr. Delahunt, even though this is a very important—or the fact that it is a very important hearing and a very important set of issues, I certainly would have wanted to have both more time for the witnesses and as much more time for those of us who are participants in this process.

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Mr. Cutler, let me do what my spouse has always asked me to do, just to remind you that Elwin Lee was a young associate of Wilmer, Cutler and Pickering, and he's always appreciated that fact as he's down in Houston now for so many years. So I just want to simply say hello to you and appreciate your presence and your service.

Mr. **CUTLER.** He's a very highly-valued associate, he was, and please give him my regards.

Ms. **JACKSON LEE.** I certainly will.

Let me ask you, one of the things that Judge Newsome said that struck my interest is the fact that it's a two-way street, and I certainly have met with a number of those individuals representing the credit cards, and also realize how valuable the credit card creditline has been to many in innercity communities, small businesses. So I think we need to look at this from a two-way perspective.

But would you not agree with Judge Newsome that there is responsible rendering of credit cards, that there needs to be responsibility on the side of those who issue credit cards and creditlines as well?

Mr. **CUTLER.** There may be some irresponsibility on the part of what I would call minor credit card issuers, Ms. Lee, but I totally agree with you—No. 1, I think that Judge Newsome's numbers that he gave you are largely anecdotal, a few cases he looked at. My understanding is that something like 96 percent of all major credit card issuer debt is repaid by the borrower and that only 4 percent doesn't get paid in the end, and an even lower percentage of major credit cardholders file for bankruptcy.

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The problem is not a credit card problem, and if the government tried to regulate the issuance of credit cards in some way, it would reduce the availability and convenience of credit cards to the poorest segments of the community, and that would be most unfortunate.

Ms. **JACKSON LEE.** Thank you.

Let me ask the chairman if I might submit in the record, with unanimous consent, my statement.

Mr. **GEKAS.** Without objection.

[The prepared statement of Ms. Jackson Lee follows:]

PREPARED STATEMENT OF SHEILA JACKSON LEE, A REPRESENTATIVE IN CONGRESS FROM THE

STATE OF TEXAS

First of all, I want to thank both the Chairman and the Ranking Member of this Subcommittee for their persistent interest in the issue of consumer bankruptcy. Today, unfortunately, the results of their diligent efforts to improve our current bankruptcy laws have presented a difficult choice for all of us. We have gathered here today for one reason, so that we might review the merits of two very different legislative proposals that have been crafted to achieve the same stated objective: a fair and equitable system of consumer bankruptcy. However, the question for us today is not whether the interested parties in this debate want justice, but whether either of these proposals as they stand are the best means to realize the true justice everyone desires.

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Honestly, I have several serious questions about the substantive effects that both of these pieces of legislation could have on potential bankruptcy filers. First of all, in Chairman Gekas' bill, H.R. 3150, I have concerns about its "needs-based" bankruptcy provisions. On its surface, who would disagree with the premise that those bankrupts who are legitimately capable of repaying their debts should be required to do so? Any bankruptcy system, which would allow creditors to be paid according to the particular financial standing of the debtor, surely appears to be fair on its surface. The problem that I have with this proposal, however, lies in its specifics. What annual income amount is a fair number to mandate entry into a Chapter 13 repayment plan? More precisely, I question whether the 75% of the national median income formula listed in H.R. 3150 is that fair number that we all are looking for. At some level, I fear that Mr. Gekas' bill places too many restrictions on those debtors that choose to file for bankruptcy.

The bankruptcy system should not punish its filers, but act as a "safety net" for those of us who are overwhelmed by the unexpected tragedies of life. This is why I must differ with the ideology behind H.R. 3150 that presumes that the majority of bankruptcy filers are individuals craftily seeking to abuse the current system. Some filers lost family members, others had severe illnesses, others lost long-term employment; all very legitimate sources of financial crisis that happen to people every day. Sure, there are debtors that abuse the bankruptcy system, but creditors abuse the current rules also. What we must strive to do in this Congress is to establish a more equitable balance between debtor and creditor interests in our reformed bankruptcy system. Ultimately, we need to strive to create a system that does not make any unfair preferences for either debtor or lender.

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As for Mr. Nadler and Mr. Conyers' bill, H.R. 3146, I have questions about those provisions which might potentially expose the home equity or 2nd mortgage loan market to severe risk. At present, H.R. 3146 does not secure home equity loans. I believe that this exclusion could have a drastic impact on the current interest rates enjoyed by home equity loan borrowers. Many people for years, and only very recently in my home state of Texas, have used these loans to pay college tuitions, renovate their homes and start new businesses. But if the interest rates for these loans (which are currently the lowest for any loan in the market) become unbearable because of the increased risk for lenders, it will be the hardworking, home-owning taxpayer that will be hurt as a result. Furthermore, the current bankruptcy laws are a disincentive for foreclosure by 2nd mortgage lenders, because these loans are deemed secured. I fear that without this protected status, the number of 2nd mortgage foreclosures may increase also.

I only use this provision as an example of an excellent bill that, at present, may unnecessary harm certain consumer and creditor interests. Unlike H.R. 3150, however, I am attracted by the ideological purpose of this bill. Mr. Nadler and Mr. Conyers' bill seeks to establish that consumer-creditor balance in the law that is essential if this bankruptcy reform effort is going to succeed, and for that I applaud them. I know that I do not have all of the answers to the questions that we all have about this crisis in consumer bankruptcy, but I do sincerely hope that we can begin to answer some of these questions, together, over the course of these sorely-needed hearings. Thank you.

Ms. **JACKSON LEE.** Let me move to you, Judge Newsome.

Thank you, Mr. Cutler.

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You, I'd like to say, bring a deep sense of reality to this process, and I appreciate your presence here. Let me tell you the world that I live in. I live in a world where my community, an innercity, predominantly minority population, are redlined. Sources of credit are nil or nonexistent. I live in a community where the GSA gave a study that said the dominant number of individuals audited by the IRS are poor Southerners. So I see the world in a different light, and I appreciate the focus that you have given this issue.

You've said, for example—you talked about the medium test. And if you'd comment on that for me. First of all, say we take 75 percent of the medium. Say we take $37,000, four people in the family. Does that mean—are you telling me that our interpretation is, if you make $50,000, which is certainly not a whole lot of money, you might be subject to this medium means testing, and not be able to utilize the kind of bankruptcy tools that you might need to utilize?

Judge **NEWSOME.** That's absolutely true.

Ms. **JACKSON LEE.** You also said, Judge Newsome, and I think it's an extremely important point—you talked about the mom and pop and desperados, financial desperados. Clearly, we have a good economy. So it seems ironic that we have this kind of bill. I think we can handle some of the real estate concerns, some of the credit card concerns, some of the—my apartment owners have come to me—without this drastic, overwhelmingly strange piece of legislation.

Do you see in your situation people running away from their debts as much as being confused about how to handle it and how to best focus themselves on providing remedy and solution?

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Judge **NEWSOME.** Well, Congresswoman, I can tell you that there is a constant stream of people that go through the clerk's office in our building who are utterly confused. Some of them don't even know they filed, because we have a problem with bankruptcy petition preparers who file bankruptcies and don't even tell the people they're filing for. But they're totally confused about what it is that's going on, not just in their bankruptcies, but in their financial lives, maybe in their lives in general. We only deal with—bankruptcy court is the only court in the country in which every problem can be solved with money.

Ms. **JACKSON LEE.** I'd like to ask the chairman for an additional 1 minute.

Mr. **GEKAS.** Without objection.

Ms. **JACKSON LEE.** I thank the chairman.

You can finish your thought.

Judge **NEWSOME.** Well, in any event, the answer to your question in short order is absolutely. This group of people is very troubled; they are very confused; they are very unsophisticated. As a result, it shows when they appear in court, and it shows in their schedules and in their statement of affairs.

Ms. **JACKSON LEE.** So if we do anything, education is key to what we might need to do?

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Judge **NEWSOME.** Absolutely.

Ms. **JACKSON LEE.** Let me ask, Judge Jones, my concern with your comment about minorities. In particular, I think Judge Newsome has hit the nail on the head. First of all, minorities don't use it because of probably lack of access to representation, and in fact, that's one of my concerns, to try and remedy the Bankruptcy Code, when people in the innercity and minorities have not had the advantage and are most victimized, if you will.

I'd like to know why, in the sense that many successive bankruptcy commissions have rejected this one-size-fits-all bankruptcy reform, why you differ with that, and why you would think that this reform process that is now before us would help minorities in any sense, and particularly those that are poor and/or working middle class, and that I probably know a lot better than most people.

Judge **JONES.** To the extent that this bill would alleviate the filing of bankruptcies of convenience, the filing because people who are well-off income-earners spent beyond their means, it would enable debts to be repaid, and therefore, the cost of credit and the availability of credit would be more widely dispersed among the population at large. When I said that my——

Ms. **JACKSON LEE.** Would that avoid redlining and lack of access to banking credit?

Judge **JONES.** Well, everybody buys things on time. I mean, not everyone gets loans from the bank to make their purchases. If your constituents go down to the Mattress Mac and buy a sofa—we're both from Houston—they'll have to pay out over 48 months, and the implicit interest rate in that payment is very, very high. To the extent that we can reduce frivolous bankruptcies, Mattress Mac's cost of credit goes down and competitive pressures, as we are seeing even now in the credit card industry, will result in lower interest rates.

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Ms. **JACKSON LEE.** My only concern is I see no documentation that it is correlated; that it would actually prove that some local seller of goods' interest rates would go down. It plays to where they are located, their consumer base, the attitudes about their consumers, whether they're minority, whether they're poor people, and I don't think those things would change in the Bankruptcy Code, frankly.

Judge **JONES.** Well, I—is that a question or——

Mr. **GEKAS.** The time of the——

Ms. **JACKSON LEE.** Well, if the chairman would allow—you can finish your sentence, Judge Jones. I would appreciate if the chairman would allow you to do so.

Mr. **GEKAS.** Please finish your sentence before I sentence you. [Laughter.]

Judge **JONES.** All right.

Ms. **JACKSON LEE.** Don't do that.

Judge **JONES.** As I apprehend what you're saying, my response would be that Economics 101 teaches us that when more people are competing to give out credit and their costs in the form of defaults are lower, that eventually they will all reach a lower sales price. We see that today with credit cards and rates going down to 5.9, 6 percent, and The Wall Street Journal article pointed out that there are people of very modest means who are able to shop among the lowest rates now, as they were not able to several years ago.

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Ms. **JACKSON LEE.** I think it's speculation.

I thank the judge for her comments.

Mr. **GEKAS.** We thank the lady, and we thank the judge.

And now we turn to the gentleman from Massachusetts or——

Mr. **DELAHUNT.** I'd be happy, but I see——

Mr. **GEKAS.** I see the gentleman from Ohio, Mr. Chabot, is here, but if he's not prepared to ask questions—or are you? The gentleman from Ohio is recognized.

Mr. **CHABOT.** I thank the chairman. I apologize for being a little bit late. My flight this morning was delayed and cancelled actually because of the weather, and so I just got in just now.

I want to thank the witnesses, and I certainly will review their testimony in greater depth after the hearing.

Judge Jones, just a couple of questions that I do have for you:

First of all, do you believe that the recent dramatic increase in consumer bankruptcies indicates that the current law is unbalanced and making it too easy for consumers to discharge their debt? And if so, could you give us your opinions relative to that?

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Judge **JONES.** I think those opinions—I don't want to repeat everything for the audience that was here earlier, but the fact that the bankruptcies have nearly doubled in 4 years that are supposed to be the most prosperous in our history is certainly grave cause for concern. It cannot simply be explained by divorce and by job loss and by medical problems. It appears to be, at least in part, a matter of convenience, in that people file bankruptcy without even defaulting on their loans. Dozens of letters and testimony before the Bankruptcy Commission indicated they are using bankruptcy as a first resort rather than a last resort for debt repayment. Gambling is also contributing seriously to the problems.

Mr. **CHABOT.** Thank you.

If either one of the other judges want to comment on that, they could. If not, I know you've already probably talked about that.

Secondly—and any one of the judges can answer this, if they'd like to—do any of you think that requiring debtors to submit their tax returns and paystubs gives creditors additional assurances to verify the income of debtors? Do you also believe that debtors who make false claims should pay costs and legal fees?

Judge **JONES.** Yes, it's very important that the paystubs and the tax returns be made available to the trustee, perhaps under requirements of confidentiality. One of our Commissioners, a bankruptcy judge from Illinois, said that the debtor's schedules are the great American novel; nobody trusts debtor schedules in this system, and yet they are filed under penalty of perjury. We have got to stop that problem.

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Mr. **CHABOT.** Okay, and, finally, credit card debt is often blamed for the rise in bankruptcies. However, isn't it true that credit card debt represents a relatively small proportion of the debt that is discharged in chapter 7? And, further, is it accurate that President Clinton in his 1997 economic report acknowledged that the Bankruptcy Reform Act of 1978 played a major role in this increase?

Judge **NEWSOME.** I would like to respond to the first question, Congressman. I did a study of 100 cases, chapter 7 cases, in Oakland. By the way, I used to be a bankruptcy judge in Cincinnati as well. I started out there as a judge.

And what I found was that some 52 percent of the unsecured, nonpriority debt in the schedules that I personally reviewed was just credit card debt. So I do not agree, based upon my 100 cases.

And I want to respond to something that Mr. Cutler, a good point Mr. Cutler made, and I think Judge Jones. This is just 100 cases. You should have at least 10 more of these before you do anything with this bill, and you can get 10 more if that's what you wish to have. And I agree, this is 100 cases, and nobody should make any decisions whatsoever based upon this 100 cases. You should get 900 more at least.

But to go back to your question, in this set of cases it was 52 percent of the debt, and that's just for Visa, Mastercard, American Express. It does not include shopping cards. It does not include gasoline credit cards.

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Mr. **CHABOT.** Would either Judge Jones or Mr. Cutler like to comment on the credit card debt aspect of it?

Mr. **CUTLER.** I've already commented, but let me just repeat that, as I understand it, something like 96 percent of all major credit card debt is paid, and only about 4 percent goes unpaid, and an even smaller percentage of the bankruptcy filings are by people who hold major credit cards.

Mr. **CHABOT.** All right, thank you. I yield back the balance of my time.

Mr. **GEKAS.** We thank the gentleman. We turn to the gentleman from Massachusetts, Mr. Delahunt.

Mr. **DELAHUNT.** Yes, thank you, Mr. Chairman.

Judge Newsome, to pick up on a point that you just made about data and securing more information, I want to make it a matter of record and bring it to your attention—back on January 14, I, along with three other members of the subcommittee, sent a request to the Congressional Budget Office posing a series of some 12 questions, which I would ask you to review because of the concern that I have that we're simply moving too quickly with data that at least I'm unsure about.

As you heard, we're getting prepared to mark up this bill for floor action in the end of April, and, if I hear you correctly, you share an unease about moving as expeditiously as that without having data.

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Judge **NEWSOME.** I'd be glad to look at the letter, sir, and I do share that unease.

Mr. **DELAHUNT.** Mr. Cutler, you mentioned that 4 percent of the debt is unpaid. Do you know what that translates to in terms of dollars and cents?

Mr. **CUTLER.** I don't, but I'd be glad to supply that number.

Mr. **DELAHUNT.** And in terms of how many cardholders actually file for bankruptcy, do you have absolute numbers on that, because——

Mr. **CUTLER.** I believe we have absolute numbers, and I'll be glad to supply them.

Mr. **DELAHUNT.** You don't have that available, though?

Mr. **CUTLER.** No. I believe it's well under the 4 percent I mentioned of unpaid debt.

Mr. **DELAHUNT.** Of unpaid debt, but that—given the number of credit cards that are in existence today, we could be talking in excess of a million or a million and a half or 2 million. Is that a——

Mr. **CUTLER.** Well——

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Mr. **DELAHUNT.** Would that be your guess?

Mr. **CUTLER.** Who file for bankruptcy?

Mr. **DELAHUNT.** Yes.

Mr. **CUTLER.** I'll have to submit that number to you, sir, but I want to emphasize, once again, that for the government to try to regulate the terms for extending credit cards to ordinary people, you will do great damage to the poorest and most deserving people who need the convenience and the financial support that a credit card gives them.

Mr. **DELAHUNT.** Well, we also might be encouraging, if there is, let's say—and I'll try to choose my words carefully—excessive dissemination of credit cards——

Mr. **CUTLER.** What kind of law are you going to write that would discourage improper or unwise credit card extension?

Mr. **DELAHUNT.** Right. Well, maybe, then, you can——

Mr. **CUTLER.** Are you going to have a commission on who can receive a credit card?

Mr. **DELAHUNT.** Well, you know, maybe—I understand that, but maybe you could explain to me, then, the underwriting rules of the credit card industry, because I, for one—and this is anecdotal, and it's an anecdote of one—I know that my family receives solicitations that probably number about four or five per week addressed to my daughters who are students now, and in some of those solicitations there are checks that all they have to do is negotiate. I just wonder if you might agree that there is at the same time a responsibility in terms of debtor behavior, a concomitant responsibility in terms of sensible underwriting rules as to who has access to credit?

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Mr. **CUTLER.** I'm here speaking for the members, the institutions that issue Visa or Mastercard cards, and I can assure you they have very good rules, and they are lowering their interest rates to meet the competition from some of the fly-by-night people you are referring to.

Mr. **DELAHUNT.** Well, again, you know, someone made a comment earlier—I think it was one of the co-sponsors, my friend from Virginia, Mr. Moran—as I see these solicitations come in, I would just simply note that the interest rates are very attractive for the first four or five months, but then seem to go back somewhere into the teens. Again, we're talking about a $40 billion loss. I don't know what debt translates to in terms of the percentage that would be applicable to credit card bankruptcies, but it would be interesting to determine, to speculate whether those result in more debt.

Mr. **CUTLER.** Well, certainly the proliferation of card issuers creates competition, and when I went to school and when I did economics, competition tends to lower prices.

Mr. **DELAHUNT.** You know, you and I must have taken that same class, Mr. Cutler, but I just haven't seen the results. Maybe the law of economics has changed somewhat.

Mr. **CUTLER.** Virtually every one of the major credit card issuers—certainly the Visa and MasterCard issuers—is a bank or financial institution of some kind subject to very close regulation, bank supervision, by State and Federal banking authorities. And you could be sure that if they were acting imprudently, they would be held in check by the regulatory authorities.

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And if we put too many regulations on, you're going to hurt or injure—reduce—the access to credit cards by people who may need them the most. And the losses on credit cards today are tolerable, manageable, and not the cause of the bankruptcy crisis.

Mr. **DELAHUNT.** If I can indulge the Chair for another minute?

Well, that statement that you just made seems to conflict with the testimony that we just heard from Judge Newsome.

Mr. **CUTLER.** That's right.

Mr. **DELAHUNT.** And, again, would you—I mean, in terms of getting it right this time, would you agree that it really makes sense for an independent study to be concluded by the Congressional Budget Office before we move maybe too rashly and too quickly in the direction of bankruptcy reform?

Mr. **CUTLER.** Congressman, as I understand it, there have been independent studies made, and one can use the need for more studies to filibuster any bill. My understanding is that there is enough responsible, independently collected data today to justify action.

Mr. **DELAHUNT.** Thank you, Mr. Cutler.

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Mr. **GEKAS.** We thank the gentleman. Does the gentleman from Michigan wish to be recognized?

Mr. **CONYERS.** Yes. Thank you very much, Chairman Gekas.

Mr. **GEKAS.** If so, yield to the gentleman 5 minutes.

Mr. **CONYERS.** Thank you very much. Welcome to the witnesses.

Mr. Lloyd Cutler, the term "super-lawyer" is used too frivolously these days, but you were a super-lawyer before other now called super-lawyers were super-lawyers, so we're honored to have you here.

Mr. **CUTLER.** I thank you for that, Mr. Conyers, but the term I do object to, people have started referring to the venerable, and I object to that. [Laughter.]

Mr. **CONYERS.** Now, I'm going to put in the record that Chief Judge Geraldine Mund of California doesn't like the Gekas provision and I regret that, Mr. Chairman, although she doesn't say that she likes the Conyers-Nadler bill at all, so——

Mr. **GEKAS.** Do you want to put that in the record?

Mr. **CONYERS.** Yes, sir, if I might.

Mr. **GEKAS.** Without objection, it will be included in the record. Can we delete the reference to the dislike of the

Gekas bill, or do you want that all in there? [Laughter.]

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Mr. **CONYERS.** I think we should——

Mr. **GEKAS.** Never mind. Without objection.

Mr. **CONYERS.** Thank you.

It was her view that—she considered both bills—and one was the Gekas bill and the other bill was—and the related bills, McCollum and Gekas: "I found that they substantially increase the workload of the court, will have widespread effect on the ability of the chapter 7 trustee to marshal and liquidate the assets of the estate, and will change the balance of rights between personal property secured creditors and real property secured creditors." I've tried to point these out in my comments and I hope that they're carefully reviewed by interested parties. And I propose to do that.

We're on a pretty tight frame here. Chairman Gekas has scheduled five panels this morning, like we don't have anything else to do but get this bill through. Now I know that there are only about, maybe less than 60 actual working days in the Congress, but we haven't—he's even providing lunch for the Members so that we won't leave the room. So, I mean, this thing is—we're on a train here, Mr. Cutler, and I'm worried about it.

I've heard some things here that leave me disturbed. I have little confidence in the Staten study. The GAO reviewed it and didn't think much of it. And I can't get over the notion that if we have 96 percent of credit cards paid, why do we need any legislation at all? I mean, 4 percent is a pretty good deal. What's the problem? If we came in with legislation for every industry that couldn't collect 4 percent of their outstanding, we'd be accommodating other industries all over the place. I think the credit card industry suffers from the problem that Mr. Delahunt alluded to, and I sure don't see how that's going to help poor or minority people.

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I mean, you can get credit and I'm glad that you characterize these as fly-by-night lenders, or whatever term that you used, but these credit cards are in the mail, floating around. I mean, if we took them up on their word, they promise you they won't see if you had bad credit or if you're credit-worthy, they send them to kids, unemployed, retirees. It's almost like any name they can find.

And then they send you or somebody like you—never as distinguished, and certainly not super-lawyers—but they send in people who then tell us: We've got to make it tighter, we've got to get these 4 percent that are defaulting. But these are the same bunch of business men that have begged everybody to please take another credit card and so, I don't buy it. I don't see a problem and I sure don't want to fix it up for the creditors.

And you're doing, Judge Jones, no minority a favor by making them more available to credit cards. As a matter of fact, African Americans overpopulate the bankruptcy court, proportionately.

So, I'd like to allow all of you to respond to these observations. Judge Newsome?

Mr. **GEKAS.** Without objection, the gentleman will be accorded an additional 2 minutes.

Mr. **CONYERS.** Thank you. Thank you, sir.

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Judge **NEWSOME.** Well, one of the things that I'd like to respond to that Mr. Cutler said was that these are somehow fly-by-night credit card companies. I don't consider Citibank, Wells Fargo, Bank of America, Chase, to be fly-by-night outfits. These are the most respected lending institutions in this country, and they showed up more often than anybody when I went through these schedules.

As far as whether or not there's an over-representation of minorities in bankruptcy court, I do not want to add to the anecdotal evidence that has been put before you and speculate about whether that's true or not. I don't know, Congressman. I don't know whether they're over-represented, but they are certainly represented.

Mr. **CONYERS.** Well, we've bailed Citibank of their foreign lenders pretty regularly—Mexico, Asia—they come with their hands out. I mean, these fellows have a nerve. And they're not fly-by-night, they're quite substantial. They don't have the super-lawyer representation, but what the heck.

Mr. **NADLER.** Would the gentleman yield for a moment?

Mr. **CONYERS.** Of course.

Mr. **NADLER.** Well, I think that what maybe you fail to realize that some of these large banks need help with the credit card losses because their credit card profits bailout their foreign losses. [Laughter.]

Mr. **CONYERS.** Would you repeat that statement, sir?

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Mr. **NADLER.** I said, they think they need help with their credit cards because their very profitable credit cards help bailout and balance their losses on foreign investments when the taxpayers or the IMF don't.

Mr. **DELAHUNT.** If the gentleman will yield?

I'll become particularly concerned when I see the name Suharto appearing on a filing. [Laughter.]

Mr. **NADLER.** We'll invite him to be one of the witnesses.

Mr. **CONYERS.** Now, the——

Mr. **GEKAS.** The time is returned to the gentleman of Michigan for the remaining 30 seconds.

Mr. **CONYERS.** Chairman Gekas, we want to get a little bit of consideration in on our bill, too, the alternative bill. And I don't know if any of the witnesses have had a chance to focus on the bill that Mr. Nadler, the ranking subcommittee member, and I have put in.

But if any of you are familiar with it, we'd appreciate it coming in for the same careful scrutiny that you've given the other legislation.

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Mr. **GEKAS.** The Chair assures the gentleman that it will receive fullest scrutiny and the panels that are scheduled for Thursday and next week will have well-balanced testimony.

Mr. **CONYERS.** Well that's great. You mean there are going to be more hearings on this?

Mr. **GEKAS.** Absolutely. Your presence here will be mandatory. [Laughter.]

Mr. **CONYERS.** Well, thank you, Mr. Chairman.

Mr. **GEKAS.** Do you yield back?

Mr. **CONYERS.** Yes, I'll yield back.

Mr. **GEKAS.** I thank the gentleman.

Judge Jones has the benefit of 1 additional minute granted to the Chair for a final statement.

Judge **JONES.** Thank you, sir, I appreciate it. I have a couple comments in response to what Congressman Conyers said. I appreciate your perception of the problem here. I think credit cards are a red herring in this debate, and you'll hear more of this in the later panels.

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But, what credit cards substitute for is the "mom and pop" grocery store, the dry-cleaner, the small retail establishment. And if credit card debt becomes less available to consumers, those establishments are also going to see a contraction of their business so it is very important that the credit card industry be treated with some understanding of the full context in which they operate.

Credit unions have suffered unprecedented losses from bankruptcy. Those come directly out of the pockets of the borrowers who are their members.

Let me give you a couple of examples of some abuses in bankruptcy that a means-testing provision would curb.

One was decided by the Supreme Court a couple days ago: A doctor committed medical malpractice on a lady and it resulted in her leg being amputated. And when she filed the medical malpractice suit, he said: Oh, I'm in bankruptcy, that's discharged.

Had there been a means test, I dare say, he would've been required to repay that obligation.

Another example: Sex harassment suit. A man is propositioning a woman and she files suit for $100,000 in damages. This appeared in an Eighth Circuit case recently, and the Eighth Circuit determined before that case was even litigated that that defendant could receive a discharge in bankruptcy.

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That is abuse. That is the kind of thing that society needs to prevent.

Mr. **NADLER.** Mr. Chairman.

Mr. **GEKAS.** The gentleman, Mr. Nadler, is yielded for the last time in this discussion 1 minute to counter the counter.

Mr. **NADLER.** Thank you, Mr. Chairman. I just want to ask Judge Jones a question. I'm a little confused.

Mr. Cutler said a moment ago, you said, "credit cards are a red herring," that that's not the real problem. Mr. Cutler says that 96 percent of the major credit card debt is repaid, it's only a problem for 4 percent, that's not the major problem.

If that is the case, then why are we also hearing, earlier in the testimony, in your testimony, that if we pass this bill, that we'll have lower credit card interest rates or there won't be upward pressure on credit card interest rates, because of the abuses that will be curbed, if to start with, the problem is not with the credit cards and 96 percent are being repaid?

Judge **JONES.** Because economics are economics, and it takes 15 good loans to make up for every bad loan.

Mr. **NADLER.** So you're saying, because that four percent has that substantial an impact on the profitability of the other 96 percent?

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Judge **JONES.** I don't understand.

Mr. **NADLER.** In other words, we've been told two things: One, there's a problem with credit cards, or, at least, you've implied there's a problem with credit cards, and if we solve that problem, the credit card interest rates would go down. Two, there is no problem with credit cards, 96 percent of the credit card debt is repaid to start with; the problem is somewhere else, that this bill has to deal with. I don't understand that contradiction.

Judge **JONES.** It's not a contradiction if——

Mr. **NADLER.** Please, explain.

Judge **JONES.** You took my—all right, I was trying to be brief.

The four percent have to do with the people who default in bankruptcy. If one could save the money from some percentage of those defaults, then you would see more profits to the credit card industry and, therefore, lower interest rates through the impact of competition.

The other business about credit cards are not "the problem," by that I meant to say that they are a proxy for other debts. So even if Judge Newsome were correct that about 50 percent, and that is a highly disputed number in my view, as to how much of bankrupt debt comes from credit cards, they stand in for what would be other kinds of debt otherwise.

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Mr. **NADLER.** Thank you, Mr. Chairman.

Mr. **GEKAS.** The gentleman's time has expired. We thank our witnesses, and we ask them to stay on tap. Not today, but for the remainder of the——

Ms. **JACKSON LEE.** Mr. Chairman.

Mr. **GEKAS** [continuing]. Of this legislation.

Ms. **JACKSON LEE.** Mr. Chairman.

Mr. **GEKAS.** Oh. I was a bit premature. The lady from Texas?

Ms. **JACKSON LEE.** Thank you very much, Mr. Chairman. The point than Judge Newsome made about, and I don't want to attribute it to you, Judge Newsome, but I know the four percent number is running around, and it's interesting. I always consider, or would like to consider, the legislative process of this body as a corrective and remedying body, so that if there is a major, penetrating problem, that we go right to it. We don't make problems where they're not.

Four percent seems to be a very low number where you could sort of narrow-in on what the issues are, and possibly respond to the egregious circumstances that Judge Jones has issued: the medical malpractice situation, the sexual harassment.

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I like your suggestion—and I know it does not apply to all situations—but as I read this 707(b), if substantial was taken out, and you just had the word "abuse," first of all, you, who are real, practicing bankruptcy judges, then get a real vast latitude.

I would think, in the questions of the doctor, who would have had to file of the various charges or assets and liabilities against him—or the attorney or whoever it was with the sexual harassment—a bankruptcy judge could see that, and with the question of abuse—and again, I know that 707, let's just take it as broad concept—wouldn't that subject itself to reasonable review and possibly questions about whether this person was filing appropriately?

Judge **NEWSOME.** May I answer, Mr. Chairman?

Mr. **GEKAS.** Yes.

Judge **NEWSOME.** Well, first of all, I think you should know that the Supreme Court ruled nine-to-nothing that that debt was dischargeable.

Ms. **JACKSON LEE.** Thank you.

Judge **NEWSOME.** But, secondly, yes, I think that could be included, and I would also like to note, I do not agree with those who have said that this means testing bill will solve the problem that it's intended to solve. If you would just take a look at case number 48 in the survey, the highest amount of credit card debt, $177,000, those debtors would pass the means test. They would end up in chapter 7, and they make over $80,000 a year; in 1994, they made over $100,000 a year.

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Ms. **JACKSON LEE.** You finish your point by saying you stand by your position: the means test does not work.

Judge **NEWSOME.** Yes, ma'am.

Ms. **JACKSON LEE.** Thank you. Thank you, Mr. Chairman.

Mr. **GEKAS.** The Chair thanks the lady, and, for the second time, we extend our gratitude and dismiss the witnesses.

We will now proceed with the third panel. Before we do, because we're going to continue through the lunch hour, I say to the people who are scheduled for panel five: Stewart Feldstein, Mark Lauritano, Professor Ausubel, and Vern McKinley. This would be an appropriate time for you to grab a cup of coffee, if you want, and return to the chamber so that you'd be in time for your section of the testimony. The same would hold true for panel four: Nicoll Russell, James Shulman, Henry Sommer, and Matthew Mason. So you can use your time as you will, between now and the time you are to testify.

We now welcome the third panel, headed by the Attorney General of the State of North Dakota, Attorney General Heidi Heitkamp, who graduated from the University of North Dakota and thereafter received her law degree from Louis and Clark Law School. She has served as North Dakota's Attorney General since 1993. Prior to that, she served as that State's Tax Commissioner for 6 years. She was appointed by the President to the Trade and Environmental Policy Advisory Committee to the Office of the U.S. Trade Representative. Today, the Attorney General appears on behalf of the National Association of Attorneys General. She chairs that organization's Bankruptcy and Taxation Working Group.

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Joining her is Karen Cosgrove, the Vice President of Business Operations of Kemp Management, on behalf of the National Multi Housing and National Apartment Association. Ms. Cosgrove appears on behalf of that Association. She has more than 20 years of experience in the field of property management. She has also experienced the bankruptcy system on both the professional and personal level. Ms. Cosgrove, herself, has been a chapter 7 debtor.

John Gleason is at the witness table. He is Vice President of Credit for Bon-Ton Department Stores of York, Pennsylvania, and appears on behalf of the National Retail Federation. In addition to his association with Bon-Ton, Mr. Gleason is a member of the National Retail Federation and is an active participant in its credit management advisory council. Bon-Ton Department Stores is a regional department store chain based in Pennsylvania with stores located in New York, West Virginia, Maryland, and New Jersey.

They are joined by Mr. Hammonds, Bruce Hammonds, senior vice chairman and chief operating officer of MBNA Corporation, which is, of course, a bank holding company. Its principal subsidiary is MBNA America Bank, NA, which is the largest independent credit card lender in the world, and one of the two largest credit card lenders overall. It has more than 20,000 employees in 28 offices located in the United States, Canada, and the United Kingdom.

Janet Kubica is the president and chief executive officer of POSTMARK Credit Union of all places, Harrisburg, Pennsylvania. She appears on behalf of Credit Union National Association. She has been active in the credit union industry since 1975. She has also served as a volunteer board member and supervisory board member of other credit unions. She is a member of the Credit Union Founders Club for chartering new credit unions, and has worked as a consultant for the Pennsylvania Credit Union League. Since 1988, she has served as president and chief executive officer of POSTMARK Credit Union, a non-for-profit cooperative financial institution. The members of POSTMARK Credit Union are primarily employees of the United States Postal Service and their families. She is currently a board member of the Harrisburg Chapter of Credit Unions, and serves on the Regulatory Review Commission of the Committee of the Pennsylvania Credit Union League. She attended the University of Pittsburgh, and lives, as I do, in Harrisburg, Pennsylvania.

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We also have with us, William Kosturko, the executive Vice President and General Counsel of People's Bank. Mr. Kosturko appears on behalf of America's Community Bankers, which is the national trade association for 2,000 savings and community financial institutions and related firms. The industry has more than $1 trillion in assets and employs 253,000 men and women. People's Bank is a community-based savings bank with $7.2 billion in assets and 90 branches. It is the leading mortgage lender to low- and moderate-income groups. In addition, it operates a large consumer credit card business.

We thank the panel. I think we should proceed in the order in which the Chair has announced their presence even though we're going to be skipping back and forth. So, I suppose it's the Attorney General first.

STATEMENT OF HEIDI HEITKAMP, ATTORNEY GENERAL, NORTH DAKOTA, ON BEHALF OF THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

Ms. **HEITKAMP.** Thank you, Mr. Chairman. For the record, my name is Heidi Heitkamp. I am the Attorney General for the State of North Dakota, and chair of the Bankruptcy and Taxation Working Group for the National Association of Attorneys General.

I've been North Dakota's Attorney General since 1993, but prior to that, served that State in the capacity of an elected tax commissioner, and was responsible for collecting tax debt for the State of North Dakota, and also had a unique opportunity to discover the workings of the financial institutions. As I was tax commissioner, I chaired a financial institution taxation working group where we discussed a number of issues, including how we source income from credit cards, and received some insight in how credit cards are issued, and on what basis. And I think additional questioning in that direction would be very useful to this committee, so you can better understand how those choices are made as you evaluate whether, in fact, due diligence is brought forth.

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I feel a little bit like the person who came to square dance at your waltz. I'm not here to talk about needs-based bankruptcy. The National Association of Attorneys General does not take a position on that particular portion of your bill. We are, instead, here to talk about the unique aspects of governmental interests, and governmental interest as they relate to the Bankruptcy Code and the difficulty that State and local governments, in particular, have had in pursuing collections and responsible corporate, in most cases, corporate and individual action relative to bankruptcy entities that we deal with every day.

I want to also reserve a little time, though, because I can't ever pass up an opportunity to get involved in a very important and significant debate, to provide, as I see it, some insights in what is happening across this country as it relates to consumer education.

And I want to skip just right to some four major portions, many of which are detailed and outlined in greater detail in my prepared testimony, but four basic provisions of this bill that reflect concerns that we have in our national association, and as collection attorneys for State and local entities.

A bankruptcy discharge is a privilege to the debtor. I think sometimes we forget and look at pursuing rights and court actions, but this truly is a privilege given to the debtor. And as such, the debtor should bear the substantial burden of ensuring that creditors receive adequate notice of what is being done and that they are fairly treated.

In return, the Code should ensure that creditors can protect their interests to the greatest extent possible under the law. Notice is absolutely critical to those efforts by creditors. But the current Code and Rules do not ensure that the government, in particular, will receive significant and meaningful notice. Instead, the Rules do not even provide, I think, governments with the bare minimum that Congress instructed in the 1978 changes.

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For instance, a notice addressed to the Attorney General of the State of North Dakota with absolutely no indication as to why that debtor believes a debt is owed to the State of North Dakota, creates enormous difficulty in my office in sorting out where that belongs: Is this an environmental claim, is this a tax claim, is this a claim that involves a consumer protection action that may have been taken by the department of commerce in some States in or, in my case, in my office? It is very difficult to sort out where that notice should be given. I think it's clear that notice is an important and critical portion of the State's protecting their interests and their rights.

Bankruptcy proceedings should be established with the goal of ensuring that all legitimate claims are actually accepted and to the extent owed; paid, if possible. I think we've had a lot of discussion today about whom we're going to point the finger at for the current crisis we're in; I think at a bottom line, the expectation of the American people and certainly all other consumers who pay their bills every day, is that there is going to be a system that does, in fact, ensure payment of debt, if that's at all possible. And that is something that I think we share concern and, I think, direction for this committee to pursue.

Procedures would be designed so that the default mode imposes the least burden on all parties in the system. And by that I mean, if the norm is you actually would grant that motion, why go through the motion process? Why not make a lot of what's done automatic so that we don't have the burden on the system that we currently have to prove what is fairly obvious in all situations.

The primary concern that we have is that bankruptcy should not be a basis for a debtor to avoid its obligations under the law applicable to all entities. Nor should the court's discretionary authority under section 105 be viewed as a general authorization to the bankruptcy court to overrule existing law on an ad hoc basis. Bankruptcy should not be seen as a way for the debtor to find a friendlier forum, a new set of substantive laws, a reversal of the burdens of proof. And I know there's been a fair amount of discussion, certainly our testimony that we presented before the Commission went to this direction, and obviously there's been a great deal of pursuit for 11th Amendment arguments in bankruptcy court, as it relates to State's sovereign rights to pursue their interests. And this continues to be and will be one of the major themes of the National Association of Attorneys General, as you progress through your deliberations.

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I want to make one final note, and it was a matter of curiosity that I noted in the bill that there is an opportunity to pilot projects on consumer education. It's been alluded to today, and the bottom line is, we're here because too many people incur too much debt and have to file bankruptcy and not pay that debt. How do we solve that problem? The, I think, high level of consumer illiteracy in this country is alarming, is absolutely alarming.

Lest you think that I'm exaggerating, we recently, in conjunction with a project that I've initiated as an attorney general, surveyed State high school superintendents and principals and asked them how many of their students are equipped today to meet the rigors of our financial environment and the economy, really meet a tax burden, really meet a consumer debt burden. Almost 80 percent said their students were not or were very little equipped.

What do we do to solve that problem?

Mr. **DELAHUNT.** Maybe, Madam Attorney General, you should have asked the principals and the teachers. That would have been a very interesting survey also, I suggest.

Ms. **HEITKAMP.** I think that when you look at it, and you look at what the needs are, I would ask this committee, as you're designing long-term solutions, which I hope include education, that you explore what is being done in every State in this country to encourage consumer education and solve this problem long-term.

Thank you, Mr. Chairman.

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[The prepared statement of Ms. Heitkamp follows:]

PREPARED STATEMENT OF HEIDI HEITKAMP, ATTORNEY GENERAL, NORTH DAKOTA, ON BEHALF OF THE NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

Mr. Chairman, Members of the Subcommittee: My name is Heidi Heitkamp. I am the Attorney General of the state of North Dakota and Chair of the Bankruptcy and Taxation Working Group of the National Association of Attorneys General. I have been Attorney General since 1993. Prior to that I was the Tax Commissioner for the state for six years. In that capacity, I was responsible for overseeing the collection of the tax revenues for the state; since becoming Attorney General, I have also become responsible for all of the other myriad of efforts carried out by my office to protect the citizens of the state, including enforcement of the environmental and consumer protection laws, and similar provisions. As such, I am well aware of the immediate and disruptive impact that even a good-faith bankruptcy filing can have on our police and regulatory efforts. When a true "bad actor" is in the picture—a scam artist, a fraudulent telemarketer, a polluter who stubbornly refuses to clean up the mess he has created—there is a real potential for bankruptcy to become a serious impediment to protecting our citizenry.

I have been asked to speak about the effects of bankruptcy on governmental actions and, broadly, what changes should be considered for the Bankruptcy Code. To make valid decisions about those issues, one must first ask, what are the societal values/goals served by allowing entities to file bankruptcy? Only when one knows what is to be accomplished is it possible to reasonably determine, what means should be used to reach that end.

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Bankruptcy serves two primary purposes: first, it is theoretically structured so as to produce greater returns for creditors than alternative systems of debt collection, including particularly an unrestrained "race to the courthouse." Second, it is meant to preserve human dignity by allowing debtors relief from oppressive levels of debt. Similarly, allowing a company to reorganize may avoid much social disruption and turmoil among employees, suppliers, and the community at large by avoiding the disintegration of a functioning business. As such, bankruptcy is, in essence, part of the safety net by which society protects its members from unexpected financial difficulties.

To an extent, the goals are complementary—individual debtors who are given a breathing spell from their creditors and use the provisions of Chapter 13 may well be able to pay more to their creditors than if they are subject to the paralyzing and debilitating pressures of constant collection activities. By the same token, they may also be able to devote more effort to being productive paying members of society in the future if they are freed from their current debts. Similarly, the theory—if not always the reality—of Chapter 11 is that a reorganized business will produce more value for creditors than a forced liquidation. On the other hand, it is also clear that efforts to assist and protect debtors from collection efforts will often be in direct contradiction to the goal of producing maximum returns for creditors. Striking a balance between these intertwined and contradictory goals is, at best, a delicate job and one which ultimately must always be somewhat imperfect.

Still while we cannot expect perfection, we are now confronting an extraordinary paradox: individual bankruptcies have soared by some 450% since 1984 at a time when the economy is, by most collective measures, doing extremely well. Joblessness and interests rates are at very favorable levels, and divorce rates have stabilized or declined. Those facts suggest that bankruptcies, which are usually blamed on factors such job losses, high interest, and the disruption of divorce, should be declining. The fact that they continue to increase dramatically leaves us all wanting answers and searching for ways to reduce the numbers of filings.

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We must all be concerned because bankruptcy is, in many ways, a challenge to the normal structure of a civilized society. The economy functions based on the assumption that debts will be paid, that laws will be obeyed, that orders to incur costs to comply with statutory obligations will be complied with, and that monetary penalties for failure to comply will apply and will "sting." If those norms can be ignored with impunity, and with little or no future consequences for the debtor, this bodes poorly for the ability of society to continue to enforce those requirements. Moreover, it suggests to the debtor's neighbors, friends, and competitors that they too should consider this method of relieving their financial concerns. Indeed, it may seem foolish not to do so.

Why is this happening? There has been, and will continue to be much debate on this topic that will be carried on by others who are far more competent to produce and analyze the data than I. Three factors are fairly obvious and well-known: overall economic conditions; societal attitudes towards filing bankruptcy; and changes in the availability of credit. The fourth is more subtle, but may be equally important: the extent to which other cords in the economic safety net have become frayed and ceased to exist. This is an argument that has been made frequently in recent months: that is, the apparent health of the economy masks the degree to which the income of individuals in the middle and lower economic levels has stagnated so that they have not shared in that prosperity. Moreover, it is argued that societal protections such as health care, unemployment benefits, and the like no longer provide adequate protection against unexpected financial crises and bankruptcy is a necessary and appropriate response to dealing with such difficulties

There is a serious concern though with allowing that last argument to justify ever-increasing bankruptcy filings. Making bankruptcy cheap, easy, and painless as a way to avoid filling the gaps in the societal safety net is a dangerous practice. It is hypocritical to the extent that it allows governments to avoid dealing forthrightly with those problems. It is bad for society because it encourages a practice that is dangerously close to financial irresponsibility and that may lead others to unfairly abuse the system. And, it is unfair to creditors who did not sign on to fill the protective role assigned to government. Forcing a creditor who simply happened to have lent money to someone who has lost his job to take the place of the unemployment system is capricious and counterproductive to any proper notion of externalizing costs. The safety net is an obligation of society and should be paid for by society as a whole—not by placing its burden randomly on lenders.

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One result of the increased filings are increasing demands that lenders should restrict consumers access to credit. While there are undoubtedly irresponsible lenders and, at times, overly aggressive marketing of credit, it is important to assure that opposition to such practices does not go too far. Low income does not automatically translate to either bad credit or financial incompetence. There is little difference between payment default ratios at any given income level and certainly not so much so that Congress should encourage moves to cut off or severely restrict credit to any particular income group. The "democratization of credit" has allowed many lower-income persons access to purchasing power that was denied to them only a decade or two ago. This has undoubtedly contributed to the unprecedented stability and growth of the economic expansion of the last fifteen years. Drawing rigid lines to bar credit to such persons could threaten, for instance, the emergence of the "micro-credit" movement, where small loans are made to persons with extremely low income with great success. Similarly, BankAmerica Corp. recently announced that it would begin making no-downpayment loans in the niche market of persons with good credit but low income. We need to be sure that efforts to discourage "irresponsible" lending do not cut off such innovative efforts to expand the benefits of home ownership to all who truly deserve it.

With that background, the Attorneys General believe that there are several "first principles" upon which any revisions to the Code should be based. These principles attempt to ensure that those who legitimately belong in bankruptcy court—the unfortunate companies and individuals that have acted in good faith but nevertheless find themselves overwhelmed by debt—are protected. On the other hand, we believe that debtors must continue to obey the law and to pay their taxes to the maximum extent possible. Bankruptcy should not be seen as a way to avoid societal obligations applicable to all. If it is claimed that those obligations are overly burdensome, then society should reconsider the offending statute directly, not allow it to be negated piecemeal at the instance of a single debtor, who benefits while all of his competitors are left with the costs and burdens of compliance. That would be unfair to them, and an open invitation for more bankruptcy filings by others seeking to avoid compliance.

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The principles which I will discuss next have been set out in various letters and other filings with the Bankruptcy Review Commission. On Thursday, March 12, the Attorneys General will be assembled for their Spring Meeting, and many of the points that I am raising here will be embodied in a resolution that will be voted on at the meeting. We are pleased to see that many of the provisions in this current bill satisfy these principles and guidelines and accord with positions previously taken by the Attorneys General.

SOME BASIC PRINCIPLES IN DESIGNING THE CODE

1. A bankruptcy discharge is a privilege being given to the debtor. As such, the debtor should bear a substantial burden of ensuring that creditors receive adequate notice of what is being done and that they are fairly treated.

This is an absolutely fundamental proposition to keep in mind. For the same reason that we do not believe that bankruptcy should be used as a way of filling holes in the safety net, we oppose any argument that bankruptcy is some sort of fundamental "right" that must be protected and, indeed, almost encouraged. While there are societal benefits to allowing bankruptcies, we should never lose sight of the disruptive and detrimental effects of such actions. And, because bankruptcy is a privilege, at a minimum, the Code must should ensure that all parties are treated fairly in the course of giving this benefit to the debtor. Creditors are not the enemy: except in unusual situations, they did nothing illegal in acquiring their claim against the debtor. Very few loans, after all, are extended at the point of a gun. If a creditor lures a consumer into a debt through unfair and deceptive practices, state consumer protection offices are ready and able to prosecute such charges. But, absent such conduct, they have a right to assume that their debts will be paid, particularly when they are the victims of wrongdoing by the debtor. At the very least, they should expect that they will be treated fairly and given an adequate opportunity to protect their interests within the confines of the existing system. Too often, now, that does not happen.

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In particular, the present Bankruptcy Code and Rules do not ensure that creditors will receive adequate notice of the filing of the case and the nature of their interests therein. Meaningful notice, received at a meaningful time, is the absolute "bottom-line" right to which creditors should be entitled. Indeed, this is not even a situation where the creditors' and debtors' interests should be viewed as being in conflict. A conscientious debtor should not expect to benefit from a bankruptcy in which his creditors are not given adequate notice of what is taking place. Moreover, full and fair notice will minimize the number of debates that will occur after the case is over about whether the claimant has received notice that is sufficient to satisfy constitutional due process concerns so as to allow discharge of his claim.

The absence of any ongoing contractual relationship between the government and the debtor makes it more difficult for the government to become aware of the case, much less that it has a basis for filing a claim. Many aspects of governmental regulation depend on self-reporting by the regulated entity or investigation based on complaints brought by individuals. Until those reports or complaints occur, the government may have no way of knowing that there is a potential monetary obligation owed to it or a regulatory problem involving a debtor. Thus, there is a critical need to ensure that the government receives early and full notice of a case filing, both in its capacity as a creditor *and* as a regulator. Moreover, because of the debtor's greater knowledge of its own affairs, such notice must also make clear the nature of potential claims that it might be subject to from the government.

We also believe that there should be strengthened and clarified provisions spelling out the consequences for failing to provide the required notice. Debtors are often either inexcusably careless about their obligations to list creditors or deliberately try to avoid notifying some creditors about the case. Yet, while creditors are subject to many stringent and unforgiving requirements that frequently result in a loss of their claim, the worst that happens to the debtors, on the other hand, is that the creditor is allowed to file a late claim. It is only in extreme circumstances that the debtor ever finally loses its right to seek a discharge of its debts. Where the debtor is receiving a gift of that magnitude, it is not too much to ask that it take its notice obligations seriously and that some meaningful consequences attend the failure to comply with those obligations.

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The present bill has two sets of provisions dealing with better notice to creditors, in general, and the government, in particular. Both have considerable merit and, although they need fine-tuning and amendments to eliminate overlapping provisions, we strongly support these types of changes and the recognition that creditors must be given a full and fair chance to protect their interests.

2. Bankruptcy procedures should be established with the goal of ensuring that all legitimate claims are actually accepted and paid to the extent possible.

Again, many provisions of the current Code and Rules seem designed more to provide an obstacle course for creditors than to assure that the debtor recognizes and deals fairly under the Code with all of its obligations. A contrary view would attempt to minimize the burdens on creditors in ensuring that their claims are listed and provided for. For instance, as the bill suggests, if the debtor concedes liability on a debt in its schedules, the Code should ensure that such a claim is allowed without requiring the creditor to file a proof of claim. This is provided for in Chapter 11 now, but not in the other Chapters. This results in scheduled claims not being paid in Chapter 13, for instance, unless a redundant claim is filed by the creditor. Similarly, unsophisticated creditors may lose out when a case is converted from Chapter 11 to another chapter because they do not realize that their claim which was deemed allowed before now must be actually filed.

3. Procedures should be designed so that the default mode imposes the least burdens. If a motion or action will be routinely approved, then it should be made the norm and the burden placed on the other party to oppose a proposed action. Similarly, if certain actions should be taken in every case prior to discharge, then verifying such actions should be part of the routine preparation of the case for confirmation/discharge.

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With the large number of cases in the system, it is imperative that the process be structured to reduce the burden on all parties to the greatest extent possible. In the words of the well-known cliche, we all must learn how to "work smarter, not harder." We should not require litigation where there is likely to be no objection to the proposed actions. Motions to allow setoffs of tax debts and refunds, for instance, are routinely granted upon request. Indeed, many local rules now no longer even require motions to lift the automatic stay to allow the setoff, but simply allow the process to go forward automatically, unless someone objects. So long as there are adequate safeguards, this procedure makes sense for all concerned and its inclusion in this bill is a welcome change.

Similarly, it is critical to ensure that other procedures are structured to work in the most time and cost-effective manner. No one has the resources to operate in a full litigation mode in dealing with a million and a half cases a year. Instead, we must require necessary information to be provided automatically, rather than requiring a discovery request. Similarly, we must ensure that the most logical party be designated to automatically provide review and recommendations on debtor compliance with its obligations under the Code. Because the U.S. Trustee or the case trustee is already obligated to review the case, the filings, the debtor's statements, and conduct, it makes sense for those parties to also review whether the debtor has complied with all of its obligations and to automatically recommend dismissal or conversion of cases if those duties are not satisfied.

The bill contains provisions in this regard with respect to both small businesses and individual debtors. In both cases it recognizes that tax compliance is a major issue and one in which the debtor has the necessary information to determine proper treatment of its obligations. Requiring the debtor to provide the Trustee several years of tax returns, and to have prior years on file before a dismissal is granted is critical to ensuring that the information the debtor provides on its schedules and in its plan is correct. It also means that tax agencies will be able to prepare valid claims based on actual information, rather than forcing them to grope blindly to estimate the debtor's tax liabilities based on inadequate or nonexistent data. Such a process is wasteful of the government's resources, can allow fraud, and is unfair to other creditors who are burdened with dealing with the inevitable modifications that result from estimated tax claims. Many courts now deal with these issues by local rules, but the coverage of such rules is spotty and their requirements are inconsistent. A clear and understandable national standard in these areas is essential to ensure that debtors know of and fulfill their obligations to pay their existing tax liabilities.

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By the same token, those appearing before the Bankruptcy Review Commission generally agreed that the debtor's failure or refusal to remain current on its postpetition taxes was the best indicator that the case was unlikely to result in a successful reorganization. Similarly, with individuals, a bankruptcy filing is meant to serve as a cut-off date; thereafter, the debtor must resume filing and paying taxes as required by law, just as with any other citizen. Bankruptcy gives debtors a "fresh start," not a "head start." And it certainly does not permanently exempt them from compliance with their financial obligations as a member of society. Thus, to the extent that the bills provide for dismissal or conversion if the debtor is delinquent on those postpetition obligations, the Attorneys General again are in agreement with those concepts.

In our view, it is neither anti-debtor nor pro-government to include provisions that ensure that returns are filed, information is provided in a manner that allows tax claims to be investigated and assessed in a reasonable fashion, and that taxes accruing postbankruptcy are paid. They do not provide new or additional priorities for the government; they do not mandate additional exceptions to discharge. Rather, these kinds of provisions appear to us to be designed simply to make sure that the Code works as intended. We support inclusion of such measures in any legislation passed by Congress.

4. Bankruptcy should not be a basis for a debtor to avoid its obligations under laws applicable to all entities (including its competitors); nor should the court's discretionary authority under Section 105 be viewed as a general authorization to the bankruptcy courts to overrule existing law on an ad hoc *Basis. Bankruptcy should not be seen as a way for the debtor to find a friendlier forum, a new set of substantive laws, or a reversal of the burdens of proof.*

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The corollary to this principle is that the government is not "just another creditor," and its unique role in bankruptcy must be recognized in order to ensure that bankruptcy is neither a haven for wrongdoers or a way for debtors to obtain unfair advantage over their competitors. The states are, in the main, involuntary creditors in bankruptcy cases. When they need to collect delinquent taxes, for instance, it is not because they have chosen (perhaps unwisely) to make a loan to the debtor. Instead, the debtor has simply availed itself of the fact that our system is based on voluntary compliance and has written itself a loan from the public treasury and from the pocketbooks of other law abiding citizens to help finance its failing operations. (*See*, H.R. No. 95–595, 95th Cong., 1st Sess. at 193, n. 123, *reprinted in* 1978 U.S. Code Cong. and Admin. News 5787, 5963, 6153–6154, which noted that "it is a frequent occurrence that the business will stop paying its taxes before it stops paying its other creditors because the officers of the business know that detection of non-payment is more difficult for the taxing authority than it is for a supplier or lender and that an unpaid supplier quickly stops shipping goods, though an unpaid taxing authority is usually unable to take collection action for months.")

Similarly, when the government pursues polluters or those who have victimized its citizens and seeks monetary restitution for the losses the wrongdoers have caused, it is not extending credit on the basis of a consensual loan for which it could seek security. Instead, it is acting after the damage has occurred and must pursue its claims as a general unsecured creditor in a situation where the debtor has often already pledged all of its assets to other parties. And, apart from some taxes and a very limited priority for consumer security deposits, there is no longer any priority for governmental claims. Thus, the government is often at a severe disadvantage in being able to collect its claims. See *U.S.* v. *Flo-Lizer, Inc. (In re Flo-Lizer, Inc.),* 916 F.2d 363, 366 (6th Cir. 1990) ("The government is not in the same position as other claimants. The IRS is given preferred treatment under the Bankruptcy Code because it cannot choose its debtors or take advance security on tax debts.") Moreover, unlike other involuntary creditors, such as tort claimants, there is normally no insurance available to pay for violations of the law. The Code has long recognized these distinctions; we urge Congress to keep them in mind when deciding what changes to make.

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At the same time, governments have unique functions—police powers, tax powers, mandated requirements, regulatory processes—which are not, and cannot, be duplicated in the private sector. The government cannot restrict its activity to only a particular portion of its territory or to a desirable segment of the population. Just as the rain falls on the just and the unjust, so too are police and fire protection given to both timely and delinquent taxpayers. Potholes outside a tax protestor's house will still be filled and his children may still attend public school, despite his failures to pay the taxes he owes. All of these services are provided from taxes and a citizen that accepts the privileges and benefits of citizenship must accept the reciprocal duties and obligations. Moreover, in a system that depends on voluntary payment of taxes, each person must also feel that his or her fellow citizens respect and obey those same obligations. A system that makes it too easy to avoid taxes risks losing not only the monies owed by the debtor but also by those who see and imitate that initial violator. In light of the unique duties owed by a government to its citizens, the bankruptcy system must be carefully tailored to ensure that it does not unduly undermine the countervailing duty that citizens owe their government and each other.

Indeed, even where the government does voluntarily extend credit or other services, it usually does so as the lender of last resort in specialized situations where commercial lenders choose not to enter the field or can do so only at unacceptably high interest rates unless government guarantees are made available. Thus, student loans, SBA loans, low-income housing and other similar endeavors all represent areas where the government occupies a unique place in the market.

In many other instances, the government does not seek direct payment to itself or even to its citizens, but rather works to ensure that the laws are obeyed by all—including the debtor. In this role, it serves both to protect its citizens and the integrity of the legislative process. Moreover, the government's ability to enforce its regulatory authority ensures that the debtor's competitors will not suffer if they remain subject to regulatory compliance costs while the debtor is exempted therefrom.

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In short, to the extent the government seeks special provisions in the Code, it does so because of the special nature of governments. It is creditor, regulator, and provider of services of last resort. At the same time that it receives exemptions from certain provisions of the Code, it is also subject to additional requirements of due process and non-discrimination that private parties are not. It is the only party whose liens may be subordinated to pay the expenses in a bankruptcy case. And, it is not just the unavoidable expenses of the trustee in a Chapter 7 case, but also those incurred in a failed Chapter 11 before it converts to a Chapter 7 case. The result is that tax revenues are being diverted from paying for schools and police and roads for our citizens to ensuring that the highly-compensated lawyers of the debtor and the creditors' committee in the Chapter 11 case receive their fees. That last point is particularly troubling in that the government, alone among all other creditors, is precluded from even being included on that creditors' committee.

The present bill adopts language that previously passed the Senate as S. 1149 that would partially eliminate that subordination provision. Clearly, the Attorneys General support those changes, although, as presently written, the bill provides substantially greater benefits to localities than to the states because of its emphasis on *ad valorem* property taxes. We still believe that it would be more appropriate to simply eliminate Section 724(b) in its entirety and urge the Committee to consider doing so.

Representatives of state government participated throughout the Bankruptcy Review Commission's process and raised many of these issues there. Other concerns, such as the exclusion of the government from creditors' committees, and the need to establish national admission policies and limit the use of burdensome local counsel requirements, have been raised with Congress when previous proposals to amend the Code have been considered. The bill presently before the committee does take up many of the points of interest to the government and we support their inclusions. Other aspects of what we seek have been dealt with in other pending legislation—most prominently, the changes to the automatic stay provisions in the Senate's Chemical Weapons Treaty bill (S. 610) and incorporated into the Iran Missile Sanctions bill (H.R. 2709) that was passed by the House last fall. The States view passage of that legislation as a high priority to ensure that they may pursue *bona fide* police and regulatory actions against debtors.

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We also hope that any bankruptcy legislation that passes that will make clear, once and for all, that filing for bankruptcy is not, and cannot be a license for failure to obey the law. If financial distress is to be allowed to justify an exception to otherwise applicable statutes and regulations, we believe that such a judgment must be made by the *legislature*, which may consider the needs and benefits of society as a whole. A single federal judge should not be authorized to decide that the laws, whether federal or state, need not be obeyed by a particular debtor, even if it *would* be easier for the debtor to reorganize if could violate the laws with impunity. Time, effort, and money are necessary to comply with virtually any law—but the elected legislature was surely aware of those issues when it chose to impose those requirements. The judiciary cannot and should not be authorized to override those legislative policy judgments on an *ad hoc* basis. There are many who disagree and seek to use bankruptcy as a sort of free-floating "Get out of jail free" card for noncomplying businesses. We hope Congress will make clear, once and for all, that Section 105 does not endow the federal judiciary with that power.

There are many other areas that are dealt with in the bill that also are of interest to the states, but I will mention only two: the first is with respect to the scope of the so-called "superdischarge" in Chapter 13 cases. The Attorneys General have been on record for some time in support of eliminating the distinction entirely or, at a minimum, ensuring that a meaningful payment obligation for such debts is required before a debtor can obtain a discharge from them in Chapter 13. The bill makes major strides in that direction, by including several more of the exceptions that are now applicable in Chapter 7—at least we would no longer face a situation where debts from fraud, larceny, assault, or even murder could be discharged in Chapter 13. We suggest only that, by now, it no longer makes sense to continue the piecemeal assimilation of the Chapter 7 exceptions and that the Committee should consider how best to deal with making the entire package of exceptions applicable in the Chapter 13 context.

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Second, the provisions in the bill that seek to ensure that debtors are better informed about their choices in bankruptcy and the consequences of filing for bankruptcy and increase the regulation of bankruptcy preparers are an important addition. Undoubtedly, at least a part of the recent increase in cases stems from persons who have been misled into filing because of the blatant falsehoods they have been told about the "benefits" they can gain from a bankruptcy case. Then, after having wasted their money on filing a petition that does not, in the end, stop them from being evicted or losing their car, those desperate consumers are further victimized postbankruptcy. A whole new set of scam artists falsely promise them that they can easily "repair" their credit and rid themselves of the stigma of bad debts, poor credit, and a bankruptcy discharge—for a price, of course. Last week, the states and the FTC announced a joint effort to combat these credit repair scams; we applaud the additional efforts in this bill to discourage those who would prey on consumers when they are at their most vulnerable.

CONCLUSION

In sum, a bankruptcy system should serve the function of providing relief for the truly unfortunate debtor without discouraging unnecessary and abusive filings. When a bankruptcy is filed, the treatment of debtors and creditors should take place on a level playing field. The court should be concerned with the need to assist the financially distressed, but they should also require the debtor to accept burdens commensurate with the benefits it is being granted, including providing adequate notice. The Code—and particularly the Rules—should not be drafted in ways that allow debtors to benefit from noncompliance with the law, while severely penalizing creditors who fail to jump through all of the new hoops erected before them. Finally, the special concerns applicable to governmental regulatory activities should be recognized and appropriately dealt with. While changes will undoubtedly be made, this bill is an important first step in ensuring that the principles espoused by the Attorneys General are recognized and implemented.

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I would like to supplement this very general statement about problems and issues we see with the current Code with additional, more detailed comments on particular provisions of the bill—as well as our suggestions for additional areas that still warrant consideration and coverage. I will be submitting this additional material for the record following this hearing.

Mr. **GEKAS.** We thank the Attorney General, and at the outset for this panel, we repeat the issue of the written statements becoming a part of the record automatically, and your oral testimony should be restricted to about 5 minutes. We now turn to Ms. Cosgrove.

STATEMENT OF KAREN COSGROVE, VICE PRESIDENT, KEMP MANAGEMENT, AUSTIN, TX, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Ms. **COSGROVE.** Chairman Gekas and members of the subcommittee, thank you for inviting me to speak today. My name is Karen Cosgrove, I'm the vice president of Kemp Management in Austin, Texas, which specializes in the management of smaller residential rental properties. I'm here today on behalf of the National Multi Housing Council and the National Apartment Association.

The rental housing industry has witnessed an increasing number of residential tenants who are manipulating the U.S. Bankruptcy Code in order to live in a property without paying rent. The source of this abuse is the automatic stay. The National Multi Housing Council, the National Apartment Association, and a broad coalition of real estate organizations believe that the Code should be amended to make clear that the automatic stay does not prevent a property owner from evicting a residential tenant in accordance with all relevant State and local landlord/tenant laws.

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In 1993, my firm leased a single family house to a couple with small children. The owner of the home was a colonel in the armed services who was stationed in Guam at the time. Before leasing the house to the couple, we ran a credit check and found that they had a joint income in excess of $6,000 a month.

Although the tenants were occasionally late in paying their rent, it was always paid with late charges. That is, until December 1994 when the tenants failed to pay rent. We sent several notices asking that they pay the rent but received no response. Finally, after sending a 3-day notice to vacate, the tenants contacted our offices and asked for an extension until the end of the month. By January 1995, the tenants had paid neither their December nor their January rent.

We decided to go the house and try and work out a repayment schedule. What we found was shocking. The house was in shambles: the oven door had been ripped off its hinges, there were holes in the sheet rock, the upstairs bathroom toilet had been ripped out of the floor, several windows were broken, and the downstairs bathroom door had been kicked in.

Before we left the house, we left the tenants a final 3-day notice to vacate. The tenants never responded to the notice so after the required 3-day notice period we filed for eviction. At the court hearing later that month, a judge granted our eviction. The next day, however, we were notified by the bankruptcy court that the tenants had filed for bankruptcy, effectively stopping our eviction. The only creditor listed in the bankruptcy filings was the colonel.

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When we filed a motion to have the automatic stay lifted, the tenants appealed. In June 1995, after 7 months of unpaid rent, 4 months after the bankruptcy court assumed jurisdiction, and after numerous continuances, the bankruptcy judge lifted the automatic stay and endorsed a settlement agreement in which the tenants agreed to vacate the house, repair all the damages, and leave the house in a clean and orderly condition. The tenants failed to comply with the settlement agreement and we were forced to return to county court to obtain a second writ of possession.

By the time we were able to finally evict the tenants, they had remained on the property 3 days after the bankruptcy judge's order, had not made any repairs, and had caused additional damage.

The overall costs to the colonel, who could not be here today because he was unable to afford the cost of traveling to Washington, was approximately $21,000. By the time the tenants were evicted, the colonel had to borrow on his life insurance, sell his stock, and run up debts on his personal credit cards. He also faced personal bankruptcy because of this ordeal. The colonel sold the house shortly thereafter, but received nothing at closing because all of the proceeds had to be used to pay for repair.

This is just one example of how some tenants are abusing the Code. And, as I understand it, such abuse by tenant debtors have become a widespread problem in many States and a growing problem in other States. A simple change in the Code that makes clear that the automatic stay does not prevent a property owner from evicting a residential tenant in accordance with all relevant State and local landlord/tenant laws would help reduce this problem.

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A broad coalition of real estate organizations, as well as a number of the commissioners on the National Bankruptcy Review Commission, support this change. By making this change, it would help alleviate the case load on the bankruptcy courts, the costs and time incurred by the property owners, and the resultant costs which are passed on to paying tenants. Additionally, tenants would not lose any of the substantial due process protections already provided under State and local landlord/tenant laws.

In closing, I would like to say that while a safety net should be in place for debtors seeking legitimate relief, such a safety net needs to be fair to all parties, including small property owners. For small property owners, such as the colonel, this has not been the case. The Code has been manipulated by tenant debtors to force property owners to provide subsidized housing.

Thank you, again, for inviting me, and I would be happy to answer any questions.

[The prepared statement of Ms. Cosgrove follows:]

PREPARED STATEMENT OF KAREN COSGROVE, VICE PRESIDENT, KEMP MANAGEMENT, AUSTIN, TX, ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

I. INTRODUCTION

Chairman Gekas and members of the Subcommittee, thank you for inviting me to speak today. My name is Karen Cosgrove. I am Vice President of Business Operations with Kemp Management, a property management firm in Austin, TX, which specializes in the management of smaller residential rental properties. I typically manage properties for individuals and for small businesses owning fewer than 100 units.

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I am here today on behalf of the National Multi Housing Council and the National Apartment Association. The National Multi Housing Council and the National Apartment Association represent many of the nation's leading firms involved in the ownership and operation of multifamily rental housing including, finance, development, construction, and management.

The rental housing industry has witnessed an increasing number of tenants who are manipulating the U.S. Bankruptcy Code ("Code") in order to live in their apartments without paying rent. The source of this abuse is the automatic stay. NMHC and NAA believe the Code should be amended to make clear that the automatic stay does not prevent a rental property owner from evicting a tenant.

II. EXAMPLE OF A FRIVOLOUS BANKRUPTCY FILING BY A RESIDENTIAL TENANT

In 1993, my firm leased a single-family house to a couple with three small children. The owner of the property is a Colonel in the armed services who was stationed in Guam at the time. The Colonel and his wife had purchased the house in the early 1980's when he was stationed at Bergstrom Air Force Base in Texas. Neither the Colonel nor his wife owned any other real property.

Before leasing the property to the couple we ran a credit check and found that the couple had a joint income in excess of $6,000 per month, which was more than sufficient to cover the $875 monthly rent for the property. While there were a few blemishes on their credit record, there was nothing to indicate what we were to face over the next two years.

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Though the tenants were occasionally late in paying their rent, their rent was always paid with late charges. That is until December 1994 when the tenants failed to pay rent. We sent them several notices asking that they pay their December rent but received no response. Finally, after sending a three-day notice to vacate for non-payment of rent, the tenants contacted our offices and asked for an extension until the end of the month.

In January 1995, the tenants still had not paid their December rent, nor had they paid their January rent. We decided to go directly to the house and try to work out a repayment schedule face to face. What we found was shocking. The house was in shambles. The oven door had been ripped off its hinges; there were large and numerous holes in the sheetrock, some with silk flowers stuck in them; you could not tell what color the carpet was due to the trash and food strewn on it; the toilet in the upstairs bathroom had been ripped out of the floor; the air conditioning compressor was in pieces; several windows were broken; and the downstairs bathroom door had been kicked in and was hanging by one hinge. Before we left the house, we gave the tenants a final three-day notice to vacate for non-payment of rent. The tenants never responded to the notice. After the required three day notice period, we filed for eviction in the Justice of the Peace Court for the Third Precinct.

In February 1995, the tenants again failed to pay rent. At the court hearing that month the judge granted our eviction and ruled that the tenants would have to pay all overdue rent. The tenants then filed a "paupers affidavit" claiming that they were financially unable to post the required bond to appeal. At the hearing on the paupers affidavit, the judge confirmed that the tenants had both the income and the assets to post the appeal bond and granted us a writ of possession. With the writ of possession in hand the constable set a date to evict the tenants. The next day, however, we were notified by the bankruptcy court that the tenants had filed for bankruptcy, effectively stopping the eviction process. The only creditor listed in the bankruptcy filing was the property owner.

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After receiving notice that the tenants had filed for bankruptcy, we immediately contacted our attorney to try to have the automatic stay lifted. In order to avoid further delays, and on the advice of counsel, we attempted to negotiate with the tenants to get them to vacate the property and to mitigate our client's damages. Following our failed attempts to negotiate a settlement, our attorney filed a motion with the court for relief from the automatic stay. The tenants then demanded a hearing before the court on our motion. During the three month period that we were waiting for the hearing, the tenants continued to live in the house without paying rent.

In June 1995, seven months after this ordeal began, and four months after the bankruptcy court assumed jurisdiction, the bankruptcy judge agreed to a settlement which our attorney had hammered out with the tenants. The settlement provided that the tenants move out of the property no later than June 12, 1995, repair all damages, and leave the property in a clean and orderly condition. On the morning of June 13 we went to the house and found that the tenants had not moved. On June 14 we went to the house again and found that the tenants had still not moved. At this point we went back to the court and obtained another writ of possession. The constable scheduled the eviction for the next day. On June 15 we arrived at the house with the constable and found that the tenants still had not moved. Three hours later we had removed all of the tenants' possessions from the house and changed the locks. The required repairs by the tenants were never made and the tenants had caused additional damage to the house. The tenants bankruptcy was dismissed in January 1996 for non-compliance with the bankruptcy rules.

The overall cost to the Colonel was approximately $21,000. The Colonel, who could not be here today because he was unable to afford the cost of traveling to Washington, DC, is still recovering from this ordeal. By the time these tenants were evicted he had had to borrow on his life insurance, sell personal stock, and run up the debts up on his personal credit cards. He also faced personal bankruptcy. The house was sold shortly thereafter and the Colonel received nothing at the closing since all the proceeds were used to pay off the debts for the repair. When the Colonel sold his house, he was forced to sell it through a VA Assumption. As a result, the Colonel cannot use his VA house purchase benefits again.

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As of this date, more than two years after the tenants were evicted from the rental property, the Colonel still faces personal financial consequences. He and his family are living in base housing in Florida, his current duty station, because all of his savings have been depleted and he cannot purchase another residence. Additionally, he is strapped with substantial credit card debts that he undertook to stay financially afloat during this period.

III. CONCLUSION

This is just one example of a non-payment of rent case. There are thousands of cases of non-payment of rent each day in Texas alone. Why these cases should get a second hearing in bankruptcy court is beyond me. Should the bankruptcy courts take the place of state eviction courts? State and local eviction procedures already provide numerous due process protections for all parties involved and many states make housing providers go through very prescriptive procedures before an eviction can occur. The bankruptcy system was established to give individuals a second chance, not to be manipulated as a tool by unscrupulous tenants to avoid eviction and live rent-free at the expense of rental housing providers.

It is my understanding that in states like California and New Jersey the problem has become epidemic causing huge losses to rental housing providers and clogging the bankruptcy courts with frivolous bankruptcy filings. A simple change in the Code that would eliminate residential tenancies from the automatic stay would help eliminate this problem. Doing so would alleviate the burden on bankruptcy courts, the burden on rental housing providers, and the costs which are passed on to paying tenants. Moreover, legitimate debtors could still rely on the protections of state property laws with respect to their apartment and the protections of the Code with respect to their assets.

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In closing I would just like to say that while there should be a safety net in place for debtors seeking legitimate relief, such a safety net needs be fair to all parties, including small businesses. For smaller housing providers, such as the Colonel, this has not been the case. The U.S. Bankruptcy Code has been used to force rental housing providers to subsidize housing for tenants who have filed for bankruptcy.

I would like to add that a broad coalition of real estate organizations support the favorable resolution of this problem, including the National Multi Housing Council, the National Apartment Association, the American Seniors Housing Association, the National Association of Home Builders, the Institute of Real Estate Management, the Manufactured Housing Institute, and the National Leased Housing Association.

It is also supported by four out of nine of the Commissioners on the National Bankruptcy Review Commission who concluded in their final report that the automatic stay "should be amended to make clear that [it] does not bar the eviction of a residential tenant whose lease or rental agreement has expired or of one who has been or is being evicted for cause by his landlord."(see footnote 8)

Again, thank you for inviting me. I would be happy to answer any questions you may have.

CHRONOLOGY OF CASE PRESENTED IN TESTIMONY

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September 1993

Tenant first rented house

December 1994

Tenants fail to make monthly rent payment of $875

Landlord attempts to work out repayment plan with tenants

January 1995

Tenants fail to make second monthly rent payment

Housing provider discovers $4,600 in damages to house
Housing provider files for eviction in Justice of the Peace Court

February 1995

Tenants fail to make third monthly rent payment
Tenants continue to damage house
Justice of the Peace Court grants eviction judgement to housing provider
Tenants file pauper's affidavit to waive filing of appeal bond
Housing provider objects to tenants' pauper's affidavit and requests hearing

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Justice of the Peace Court holds that tenants cannot file pauper's affidavit (tenants' combined income is $6,000)
Constable attempts to enforce eviction judgement against tenants
Tenants file for bankruptcy effectively stopping eviction judgement (landlord is only creditor listed on the schedule)

March 1995

Tenants fail to make fourth monthly rent payment
Tenants continue to damage house
Housing provider's attorney and tenants' attorney negotiate settlement
Tenants refuse to agree to settlement
Housing provider files for relief from stay with bankruptcy court.

April 1995

Tenants fail to make fifth monthly rent payment
Tenants continue to damage house
Tenants request hearing in bankruptcy court.

May 1995

Tenants fail to make sixth monthly rent payment
Tenants continue to damage house

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June 1995

Bankruptcy court holds that tenants must move out of house by June 12th and pay damages
Tenants move out of house on June 15th

Thereafter

Bankruptcy trustee dismisses tenants' bankruptcy filing for failure to file bankruptcy reorganization plan (Plan filed but not complied with)

Mr. **GEKAS.** We thank the lady and turn to Mr. Gleason.

STATEMENT OF JOHN J. GLEASON, VICE PRESIDENT OF CREDIT, BON–TON DEPARTMENT STORES, ON BEHALF OF THE NATIONAL RETAIL FEDERATION

Mr. **GLEASON.** Good morning, my name is John Gleason. I'm vice president of credit for the Bon-Ton Department Stores. Today I am testifying on behalf of the National Retail Federation.

Bankruptcies are out of control. In the past 2 years, national filings have risen nearly 60 percent, exceeding 1.3 million. In Pennsylvania, where we are based, chapter 7 filings have grown by 81 percent in that same period.

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Mr. Chairman, I'd like to put these numbers in perspective. We have a strong economy, a record-setting stock market, the lowest unemployment in 24 years; the public is optimistic about the future. And, yet, in 1997, approximately 1 in every 80 households filed for bankruptcy. Even more astonishing, someone files for bankruptcy in the United States every 24 seconds.

It is estimated that over $40 billion was written off in bankruptcy losses last year. This amounts to the discharge of at least $110 million every day. That $40 billion ultimately gets paid by the nation's 100 million households, costing each of us an average of $400. Mr. Chairman, can you imagine what would happen to these numbers if our country were in a recession?

At my company, our net income for 1997 was $9.4 million or only 1.5 percent of sales. During this period, our bankruptcy losses totaled $2.2 million and represented 24 percent of our net income. While I realize that we cannot eliminate bankruptcy losses—bankruptcy must remain an option for those who have experienced serious financial setbacks and who have no other means of recovering. We must be very careful to distinguish the average filer who uses the system properly from that smaller but growing group of others who misuse the system for their benefit.

I believe that changing consumer attitudes regarding personal responsibility, and inherent flaws in our bankruptcy process, have caused many individuals who do not need full bankruptcy relief to turn to the system. They use it to wipe out their debts without ever making a serious effort to repay. Some of this change results from a decline in the stigma traditionally associated with bankruptcy.

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Let me cite three examples:

I have a customer who has had an individual account with the Bon-Ton since 1976 with a $5,000 credit limit. As recently as last September, he made a $2,700 monthly payment. On November 26, he purchased over $3,000 in merchandise which brought his balance to $3,900. On December 15, he filed a chapter 7 joint bankruptcy petition. His wife then applied for an individual account on November 21, three weeks before being included in the petition. It was opened with a $1,000 credit limit. She made her last purchase on February 1, 1998, and has a balance of $1,044. They have the same attorney and we may sue for fraud.

Many people are aware that purchases made within 60 days of filing will be excluded from the bankruptcy; they then charge to the limit 61 to 70 days prior to filing.

Here's a customer that opened an account in 1994, and never missed a payment. She then purchased $1,300 on December 15 and filed bankruptcy on February 19.

Finally, this one is my favorite. It happened at a West coast department store in February of 1997. Two women were shopping at the cosmetics counter. One tells the other, "I sure wish I could afford this gift." The other responds to her friend, "oh, let me take care of that for you." The friend says, "no, I don't want you to have to pay for this." She leans toward her friend and the sales associate overhears her say, "no, no, no, don't worry, I'm filing bankruptcy tomorrow, I'm on a shopping spree."

These are just three examples of abuse, but similar cases can be found daily at most credit offices across the country.

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Individuals must have a good credit history to qualify for and continue to use a Bon-Ton credit account. Yet we, like other retail credit grantors, have been receiving bankruptcy filings without warning from individuals who have been solid customers for years. In fact, about 40 percent of the filings we receive are from customers whose accounts are either current or not seriously delinquent.

Professor Mike Staten at Georgetown University analyzed thousands of chapter 7 petitions in courts all over the country. He found that 25 percent of the filers had the ability to repay from a third to 100 percent of what they owed. Five percent could have repaid 100 percent of what they owed. These findings have been supported by a recent study by Ernst & Young, which revealed that 25 percent could pay back an average of 45 percent over 5 years.

In the House, the esteemed chairman of this subcommittee, Congressman Gekas, along with Representatives Boucher, McCollum and Moran, have introduced H.R. 3150 which would establish a very simple gatekeeper mechanism for the Nation's bankruptcy courts. After deducting living expenses and secured and priority obligations, it would calculate whether there remains income to pay a significant portion of filer's unsecured debts. If not, the person could choose chapter 7 or 13, as they saw fit. But if they could, they would be directed to file chapter 13. Making the determination up front, before the individual gets into the court system, is far more efficient than other approaches.

The individual would still receive bankruptcy relief but they would receive the amount of relief they actually needed. If individuals made less than 75 percent of the median income, or couldn't afford to repay 20 percent of their unsecured debt, H.R. 3150 would allow them to file chapter 7 without question.

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If, on the other hand, a person could afford to repay 40 percent or more, H.R. 3150 would require him to repay what he could afford and the court would wipe out the remainder.

We strongly urge Congress to adopt such an approach.

Mr. **GEKAS.** We thank——

Mr. **GLEASON.** Thirty more seconds and I'll be wrapped up?

Mr. **GEKAS.** Without reluctance.

Mr. **GLEASON.** Say what?

Mr. **GEKAS.** Without reluctance, I grant it.

Mr. **GLEASON.** Thank you.

Senators Grassley and Durbin have introduced S. 1301 which attempts to reach the same result. However, the mechanism in their bill does not kick in until after the petitions have been filed. At that point, parties could petition the court to move the filing from chapter 7 to 13.

Frankly, for retailers such as the Bon-Ton, the proposed Senate approach would not work. Our average bankruptcy loss is $490. To spend hundreds of dollars in an uncertain effort to move a petition to chapter 13 does not make economic sense to recover $150 spread out over 5 years.

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This is why the National Retail Federation so strongly supports the simple, up-front approach contained in H.R. 3150. Thank you.

[The prepared statement of Mr. Gleason follows:]

PREPARED STATEMENT OF JOHN J. GLEASON, VICE PRESIDENT OF CREDIT, BON-TON DEPARTMENT

STORES, ON BEHALF OF THE NATIONAL RETAIL FEDERATION

Good Morning. My name John Gleason. I am Vice President of Credit for the Bon-Ton Department Stores. Bon-Ton is a regional department store chain primarily located in Pennsylvania, New York, West Virginia, Maryland and New Jersey. I am testifying on behalf of the National Retail Federation. Bon-Ton stores is a member of the NRF and I am an active participant of its Credit Management Advisory Council. I would like to thank the Chairman for providing me with the opportunity to testify before this distinguished committee.

By way of background, the National Retail Federation is the world's largest retail trade association with membership that includes the leading department, specialty, discount, mass merchandise and independent stores, as well as 32 national and 50 state associations. NRF members represent an industry that encompasses over 1.4 million U.S. retail establishments, employs more than 20 million people, 1 in 5 American workers, and registered 1996 sales of nearly $2.5 trillion. NRF's members and the consumers to whom they sell, are greatly affected by the recent surge in consumer bankruptcies.

Bankruptcies are out of control. In the past two years, national filings have risen nearly sixty percent (60%). In Pennsylvania where we are based, Chapter 7 bankruptcies have grown by 81% in that same time period. In New York, the home state of the Ranking Member Congressman Nadler, Chapter 7 filings have increased 73%. In 1997, the U.S. broke the one million filing record that had been set only the year before. Last year there were more than 1.3 million bankruptcy filings, the overwhelming majority of which (more than 95%) were consumer filings.

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Mr. Chairman, I would like to put these numbers in perspective. We have a strong economy, a record setting stock market, the lowest unemployment in 24 years; the public is optimistic about the future. And yet, approximately one in every 80 households in America filed for bankruptcy—just in the past year. Even more astonishing, someone files for bankruptcy in the U.S. every 24 seconds.

Bankruptcy filings are nearly four times higher now than they were during the much worse economic conditions that prevailed in 1980. Moreover, the number of filings are eight times what they were during the Great Depression. Rational economics does not explain this increase in filings. But a continuation of this level of filings will wreak economic havoc upon our economy.

It is estimated that over $40 billion was written off in bankruptcy losses last year—which amounts to the discharge of at least $110 million every day. This money does not just disappear. The cost of these losses and unpaid debts are borne by everyone else. When an individual declares bankruptcy rather than pay the $300 they may owe to Bon-Ton, or the $1,000 they may owe in state taxes or other bills, they force the rest of us to pick up their expenses. Everyone else's taxes are higher, everyone else's credit is tighter and everyone else pays more for merchandise as a result of those who choose to walk away. That $40 billion ultimately gets paid by the nation's 100 million households. Last year, to make up for these losses, it cost each of our households an average of $400. This year's number threatens to be even higher ($450).

Now I want to be clear. We cannot eliminate all of these losses. Some of them are unavoidable. Bankruptcy must remain an option for those who have experienced serious financial setbacks and who have no other means of recovering. The bankruptcy system exists to help those who have suffered a catastrophic accident, illness or divorce, or those who have experienced the loss of a business or job from which they cannot otherwise recover. It is both the last resort and the safety net for people in trouble. The knowledge that the bankruptcy system exists to catch them on a financial fall, even though it might never be used, is important. Finally, most people who file for bankruptcy need relief. We must be very careful to distinguish the average filer, who uses the system properly, from that smaller, but important group of others who misuse the system for their benefit.

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It is the trend with which we must be concerned. We believe changing consumer attitudes regarding personal responsibility and inherent flaws in our bankruptcy process have caused many individuals, who do not need full bankruptcy relief, to turn to the system regardless. They use it to wipe out their debts, without ever making a serious effort to repay. Some of this change in usage results from a decline in the stigma traditionally associated with filing for bankruptcy. Some of it results from suggestions by others urging individuals to use bankruptcy to "beat the system." Whatever the cause, it must be stopped.

My experience at Bon-Ton, and that of other credit managers at other stores with whom I have spoken, convinces me of this fact. For example, for many years we have tracked the payment history of those of our customers who carry and use the Bon-Ton card. The vast majority of our customers pay as agreed. In the past, however, we would occasionally see customers whose payment patterns were more erratic. They might fall behind by a few months, make payments to catch up, fall a couple of months behind again, attempt to recover, and so forth. This kind of payment history suggested to us that the customer was experiencing some sort of financial difficulty. We would monitor the account and intervene as necessary, perhaps by suggesting consumer credit counseling or by limiting their credit line so as to minimize the amount of damage, prior to their possibly experiencing a financial failure.

Today, however, we are seeing a very different picture. Often the first indication we receive that an individual is experiencing financial difficulty is when we receive notice of his bankruptcy petition. At Bon-Ton, about 40% of the bankruptcy petitions we receive are from customers who are *current* with their accounts. The first indication of a problem is the notice that they have filed for bankruptcy. It appears that increasingly, bankruptcy is becoming a first step rather than a last resort.

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Individuals must have a good credit history to qualify for and continue to use a Bon-Ton card. Yet we, and other retail credit grantors have been receiving bankruptcy filings, without warning, from individuals who have been solid customers for years.

We all experience temporary financial reversals in life. Most of us learn that, if you grit your teeth and tighten your belt a notch, you can get through it. But many people no longer see it that way. The rising bankruptcy filings reflect this. Professor Mike Staten at Georgetown University analyzed thousands of Chapter 7 bankruptcy petitions in courts all over the country. His review of debtors' own financial statements gives a strong indication of what is going wrong.

Individuals have a choice as to whether to file in Chapter 7, which generally wipes out all their unsecured debt, or they can file in Chapter 13, often known as a wage-earner plan. Instead of wiping out everything, a Chapter 13 filer attempts to repay as much as he or she can afford and the court discharges the rest. Not surprisingly, most people choose to file in Chapter 7.

Although it was the largest bankruptcy study ever undertaken, Professor Staten's study used essentially the same methodology as had researchers before him. He made two important findings. The first was that the *average* person filing in Chapter 7 *is* in serious financial trouble. That is not unexpected. Other researchers had found this, and this is what one would hope to find. Most people are honest and use the bankruptcy laws as they are intended. But Professor Staten did something that other researchers had not done. He looked more closely at subgroups within the Chapter 7 filers; and he discovered that they were not at all alike.

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He found that while the typical bankruptcy filer needs relief, and uses bankruptcy properly, a large number of filers do not. He discovered that many bankruptcy filers did not need the complete wipe out of debts that Chapter 7 provides. In fact, based on the filers' own schedules, he found that twenty-five percent (25%) of filers had the ability to repay anywhere from 33% to 100% of what they owed had they instead been in a Chapter 13 plan. Five percent of those individuals could have repaid 100% of what they owed. Instead, they chose a Chapter that allowed them to shift their debts onto the rest of us.

The findings in Mr. Staten's report were recently supported by another study conducted by Ernst and Young LLP. Ernst and Young analyzed the capacity to repay using a different data base (of more than 5,700 Chapter 7 petitions) and examining different cities than those looked at by Mr. Staten. The Ernst and Young findings were not only consistent with Staten's study, but actually showed a higher capacity to repay. Specifically, the study revealed that twenty five percent of bankruptcy filers could pay an average of at least 45 percent of their debt over a five-year period.

Why are so many persons asking the court to make others repay their debts for them? Why aren't they ashamed to go into bankruptcy court? We think that there are a number of factors.

Part of it is lawyer advertising. You don't need to stay up very late at night to see ads on TV by lawyers promising to make individuals' debts disappear (Call 1–800–DEBT FREE). Some of these ads are very aggressive. Some don't even mention bankruptcy—they talk about "restructuring" your finances. I question whether they inform their clients about the serious downsides of filing for bankruptcy. I doubt many of them do. I have heard of cases where all of the preparatory work is done by clerk typists. The client never meets the lawyer until he or she gets to the courthouse. That's a little late to begin financial planning. I firmly believe these "bankruptcy mills" are part of the problem.

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I also believe that part of the problem is the declining social stigma associated with filing for bankruptcy. At a time when 1 in every 80 households files for bankruptcy, everyone knows someone, or knows of someone, who has recently declared. Many of these individuals keep their house and their car. They seem to have access to credit (although in many cases what they actually have is a secured credit card—they put $500 in the bank and they get a card with a $500 "credit line"). And their friends and neighbors, not seeing the details of your life that bankruptcy disrupts, assume that bankruptcy is not such a bad situation.

In addition, there have been many high profile celebrity bankruptcies, including Burt Reynolds, Kim Basinger and Toni Braxton. These individuals have extravagant salaries and lifestyles. They declare bankruptcy and yet continue to receive media acclaim. I can't help but believe that this sends a message to the public. For many people, the stigma of bankruptcy is fast disappearing.

Finally, these changes have revealed a flaw in the system itself. Our bankruptcy code allows individuals to choose the chapter they wish, regardless of need. If shame won't keep the subgroup of filers who could repay from either filing or filing in the wrong Chapter, Congress needs to establish a mechanism that will. It must be simple, efficient and fair. Fortunately, some members of Congress are attempting to do just that.

In the House, the esteemed Chairman of this Subcommittee, Congressman Gekas, along with Representatives Boucher, McCollum and Moran, have introduced H.R. 3150. It incorporates H.R. 2500, previously introduced with broad bi-partisan support by Representatives McCollum and Boucher. H.R. 3150 would establish a very simple gatekeeper mechanism for the nation's bankruptcy courts. Individuals would have their attorneys fill out essentially the same forms they fill out now. H.R. 3150 would add a few additional lines. After deducting living expenses, secured (typically house and car loans) and priority (such as child support) obligations, it would calculate whether there remained income to pay a significant portion of the filer's unsecured debts. If there was not, the person would choose Chapter 7 or 13 as they saw fit. But if they could make a significant repayment, the calculation would direct them to Chapter 13. Making the determination "up-front," before the individual gets into the court system, is far more efficient than other approaches.

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Individuals would still receive bankruptcy relief; they would receive the amount of relief they actually needed. Misuse of the system is not a problem of the poor. The problems are occurring among the middle and upper middle income filers. H.R. 3150 recognizes this. If individuals made less than 75% of the median income or couldn't afford to repay 20% of their unsecured debt, H.R. 3150 would allow them to file in Chapter 7 without question. On the other hand, if an individual could afford to repay 40% of what he owed, H.R. 3150 would require him to repay what he could afford, and the court would wipe out the other 60%. We strongly urge Congress to adopt such an approach.

On the other side of Capitol Hill, Senators Grassley and Durbin have introduced a bill, S. 1301, which attempts to reach the same result. While we believe that their intentions are good, the proposed mechanism in that bill is too complicated to be useful. First of all, the mechanism in that bill, designed to direct individuals to the correct Chapter, does not kick in until *after* individuals have filed their petitions. At that point, parties could petition the court to move the filing from Chapter 7 to Chapter 13. However, the movement could not be granted unless several complicated showings were made. (One would have to show that the individual could afford to repay; that they had engaged in some sort of abuse; and that no efforts to compromise the debt had been improperly rejected.)

Frankly, for retailers such as the Bon-Ton stores, the proposed Senate approach would not work. A typical balance on a Bon Ton card for a customer in bankruptcy is approximately $490. A recovery in a Chapter 13 proceeding might be 30 cents on the dollar. It would not make economic sense for Bon Ton to spend hundreds or more dollars in an uncertain effort to move a petition from Chapter 7 to Chapter 13 to recover $150 spread over a five year period—which would amount to less than $5 a month. This is not to say that $150 isn't important to us. With tens of thousands of individuals filing for bankruptcy, those $150 claims add up. It is just that the approach in S. 1301, as a practical matter, won't be used by us, or by any other retailer. This is why the National Retail Federation so strongly supports the simple, up-front approach contained in the House bill.

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In closing, on behalf of the National Retail Federation, we urge members of Congress to take swift legislative action to address the problems confronting the nation's bankruptcy system. Otherwise, in the not too distant future, we may find that among a large segment of our society, bankruptcy filings will become the rule, rather than the exception. If we are not careful, the costs of the rising flood of discretionary filings may tax society's compassion for those in genuine need. We must not allow that to happen. I believe that it is imperative that Congress pass common sense bankruptcy reform legislation this year, consistent with H.R. 3150, that is fair, simple and workable.

Mr. **GEKAS.** We thank you. We now turn to Mr. Hammonds.

STATEMENT OF BRUCE L. HAMMONDS, SENIOR VICE CHAIRMAN AND CHIEF OPERATING OFFICER, MBNA CORPORATION

Mr. **HAMMONDS.** Mr. Chairman and members of the subcommittee, my name is Bruce Hammonds, I am senior vice chairman and chief executive officer of MBNA Corporation, the second largest credit card lender in the world. I appreciate the opportunity to appear today before the subcommittee.

The skyrocketing rise in consumer bankruptcies has impacted nearly every lender, large and small, in every segment of the lending community. In fact, more than $40 billion in consumer debt—about $400 for each American family—was erased as a result of bankruptcy in 1997.

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This underscores the fact that while bankruptcy is an important protection for debtors who need it, today's system most harms the great majority of Americans who continue to pay their debts because they ultimately bear the costs of bankruptcy losses in the form of higher prices for goods and services. The current bankruptcy system needlessly harms everyone because of a fundamental flaw. It allows a debtor to discharge debts, even if the debtor can repay some or all of those debts. In fact, today, a debtor may discharge his or her debts without ever demonstrating actual need for such relief.

To address this flaw, the Bankruptcy Code must be amended so that a debtor that needs bankruptcy protection will receive it but only to the extent of that need. This is essential to ensure fairness for consumers and creditors, alike. We believe that H.R. 3150 would efficiently and fairly implement the kinds of needs-based bankruptcy approach that is necessary.

H.R. 3150 would establish clear, objective standards for determining a debtors' repayment capacity. These standards are as follows: If the debtor can pay all of his or her secured debt payments, priority debts, and living expenses, and still have sufficient remaining income to pay a portion of unsecured debts, the debtor will be required to enter into a chapter 13 repayment plan. If the debtor cannot repay, the debtor could freely choose to file under chapter 7.

H.R. 3150 also would assign debtors to the appropriate chapter, that is to chapter 7 or chapter 13, at the start of the bankruptcy case. This would drastically reduce the number of costly and needless disputes that occur in today's system.

This brings me to an important point. H.R. 3150 needs-based bankruptcy approach would create enormous efficiencies. It would actually reduce the overall cost of consumer bankruptcy by decreasing the litigation disputes that result from today's system. H.R. 3150 needs-based system would largely run itself. The vast majority of cases would move routinely through the system and disputes would be limited to exceptional cases.

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By contrast, the needs-based approach of H.R. 3146 would allow debtors to freely choose to file in chapter 7 or chapter 13, and then require any disputes about debtor repayment capacity to be litigated by the parties in a separate judicial proceeding. As part of this litigation, H.R. 3146 will require a court to make determinations based on subjective standards. Such litigation, particularly when based on subjective standards, would be inefficient and costly. It would require additional court time, judicial decisions, and legal fees.

Without systematic needs-based bankruptcy relief, like that provided by H.R. 3150, the system will continue to be arbitrary, wasteful and unfair to the great majority of consumers who pay for the system but don't use it. Unless this flaw is addressed, controversy about consumer bankruptcy will continue to intensify.

Finally, I would like to address several myths you're likely to hear. One is that the bankruptcy is not broken. Instead, some say the credit cards are the real cause of the explosion in personal bankruptcies. This claim is absolutely false. The evidence does not support it. More than 96 percent of credit card accounts pay as agreed, and only about 1 percent end up in bankruptcy. Bank card debt comprises less than 16 percent of total debt on the average bankruptcy petition. And a recent Federal Reserve Board survey found that credit card account for a mere 3.7 percent of consumer debt. Obviously, these figures are not large enough to be the cause of the bankruptcy crisis.

Another myth is that lenders are offering credit willy-nilly to people who cannot handle it. Once again, this simply is not true. Card issuers use sophisticated underwriting techniques to ensure that those who receive credit offers have a demonstrated ability and willingness to repay their debts.

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Let me tell you how we do it at MBNA. When we receive a customer application, we pull a full credit report and do a debt-to-income analysis. We call back over 20 percent of the customers to obtain additional information, then an analyst makes a decision to approve or decline the account. If it is approved, a risk rating is applied and often a senior lender sign-off is also required. We believe we are making the right decision every time.

The majority of bankruptcies in our file are on customers that have been with us for more than 3 years. Fewer than 5 percent of our bankruptcies occur when accounts had been opened in the past year.

I thank the subcommittee for the opportunity to present these views, and I would be happy to answer any questions you many have.

[The prepared statement of Mr. Hammonds follows:]

PREPARED STATEMENT OF BRUCE L. HAMMONDS, SENIOR VICE CHAIRMAN AND CHIEF OPERATING OFFICER, MBNA CORPORATION

Chairman Gekas and Members of the Subcommittee, my name is Bruce L. Hammonds and I am Senior Vice Chairman and Chief Operating Officer of MBNA Corporation ("MBNA").(see footnote 9) My responsibilities include overseeing MBNA's credit, loss prevention, customer satisfaction, consumer finance and loan review activities. I have 28 years of experience in consumer lending, and have been a member of the MBNA management team since 1982.

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I appreciate the opportunity to appear today before the Commercial and Administrative Law Subcommittee ("Subcommittee") of the Committee on the Judiciary, United States House of Representatives, to discuss our views on consumer bankruptcy issues. I hope that this statement will be helpful to the Subcommittee in its deliberations on the nature of the consumer bankruptcy reforms that are presently needed.

OVERVIEW

Despite an extraordinarily strong economy, personal bankruptcy filings in the U.S. have skyrocketed in recent years. During 1997, there were more than 1.3 million personal bankruptcy filings, an all-time record and nearly a 19% increase over the number of consumer bankruptcy filings in 1996. By comparison, the number of consumer bankruptcy filings in 1980 totaled 287,570. This means that the number of consumer bankruptcy filings in 1997 *represents an increase of more than 360% since 1980.*

These bankruptcy filings generate huge losses. While MBNA's credit card losses have consistently been among the lowest in the business, this precipitous increase in the number of consumer bankruptcy filings has impacted virtually every lender, large and small, in nearly every sector of the credit granting community. In fact, it is estimated that more than $40 billion in consumer debt—approximately $400 for each American family—was erased as a result of bankruptcy in 1997. Inevitably, these losses are passed on to all consumers in the form of higher rates and higher prices for goods and services.

Despite the magnitude of these losses, bankcard issuers and the credit granting community more broadly believe that bankruptcy is an important protection for consumers who are severely overburdened financially. It should be noted, however, that as bankruptcy losses grow, it is those American consumers who continue to pay their debts who ultimately suffer the most because it is they who bear the cost of bankruptcy losses in the form of higher credit prices. Consumers also are harmed by increased bankruptcies when creditors, in an effort to reduce losses, tighten their credit standards and thereby decrease credit availability. As the Congress considers reform of the Federal bankruptcy system, it is critically important to keep in mind the adverse consequences bankruptcy has on the vast majority of consumers who continue to pay their debts. The basic requirements of fairness demand that a balance be restored between the interests of these consumers and the interests of those consumers who need bankruptcy relief.

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THE FUNDAMENTAL FLAW

Unfortunately, today's consumer bankruptcy system does not strike that balance. The current bankruptcy system unnecessarily harms consumers and creditors alike because of a fundamental flaw—*it allows a debtor to discharge debts even if the debtor can repay some or all of those debts.* In fact, under the current Bankruptcy Code, an individual debtor may obtain a discharge from contractual debt obligations without ever demonstrating actual need for this relief. To put it in context, this means that in 1997 alone, the Federal consumer bankruptcy system provided an estimated $40 billion of relief to debtors without either objective standards or systematic procedures for determining the actual relief needed by debtors.

This flaw undermines not only the integrity of the U.S. bankruptcy system, but also traditional obligations of individual responsibility. Moreover, the current bankruptcy system also fails the debtors it is intended to help, because it provides short-term relief without helping debtors avoid the same financial failure in the future. In short, the lack of objective and systematic procedures for determining debtor relief produces a bankruptcy process which, for both debtors and creditors, is needlessly costly and time consuming. The bottom line is that this flaw must be remedied if the consumer bankruptcy system is to be workable and fair to consumers and creditors alike.

H.R. 3150 IMPLEMENTS NEEDS-BASED BANKRUPTCY EFFECTIVELY AND FAIRLY

To address this flaw, the Bankruptcy Code must be amended so that a debtor who needs bankruptcy protection will receive it, but only to the extent of that need. This approach would match the bankruptcy relief provided by the Code to the debtor's actual need and is essential to ensure fairness for all parties impacted by the bankruptcy process. Bankcard issuers believe that the needs-based approach contained in H.R. 3150, introduced by Chairman Gekas, Representative Moran, Representative McCollum, and Representative Boucher, would efficiently and fairly implement the kind of needs-based bankruptcy approach that is necessary. We are joined in our strong support for H.R. 3150 by representatives of virtually every segment of the consumer credit granting community.(see footnote 10)

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H.R. 3150 would amend the Bankruptcy Code to establish clear and objective standards for determining a debtor's repayment capacity. These standards are as follows: if the debtor can pay all of his or her secured debt payments, priority debts and living expenses and still have sufficient remaining income to repay some portion of his or her unsecured debts above a statutory minimum, the debtor would be required to repay that portion through a Chapter 13 repayment plan, if the debtor seeks the protection of the Bankruptcy Code. If the debtor cannot repay, the debtor could freely choose to file under Chapter 7.

Moreover, H.R. 3150 would assign debtors to the appropriate chapter—that is, to Chapter 7 or to Chapter 13—at the *start* of the bankruptcy case. This would drastically reduce the number of costly and time-consuming disputes that occur in today's system, in which a debtor's Chapter 7 filing usually may be challenged only after the case is well under way and only through a separate judicial procedure. Once H.R. 3150's needs-based bankruptcy system is established, the Federal bankruptcy system will largely run itself and disputes will be limited to exceptional cases.

SYSTEMATIC NEEDS-BASED BANKRUPTCY CREATES ENORMOUS EFFICIENCIES

This brings me to a very important point. While fundamental fairness alone dictates that a needs-based bankruptcy system be adopted, it should be noted that the implementation of H.R. 3150's needs-based bankruptcy approach also would *introduce enormous efficiencies into the bankruptcy system.* H.R. 3150's needs-based bankruptcy approach would actually reduce the overall costs of consumer bankruptcy by decreasing the litigation and disputes that result from today's arbitrary bankruptcy system. Under the bill, based on a simple calculation performed by the debtor and easily verified by the trustee, individuals who can repay some portion of their debt would automatically enter a Chapter 13 repayment plan, and those who cannot would be free to enter into Chapter 7. As noted above, H.R. 3150's needs-based bankruptcy system would largely run itself: the vast majority of bankruptcy cases would travel routinely and efficiently through the system, and disputes would be limited to exceptional cases.

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By contrast, the needs-based bankruptcy approach contained in H.R. 3146 would allow debtors to freely choose whether to file in Chapter 7 or Chapter 13, and then require disputes about debtor repayment capacity to be litigated by the parties in a separate judicial proceeding. Furthermore, as part of such litigation, H.R. 3146 would require a court to make determinations based on *subjective* standards. Specifically, under H.R. 3146 a bankruptcy judge could dismiss a case as an abuse of the provisions of the Bankruptcy Code only if the judge finds that the debtor could repay *all* of his or her debts while maintaining a "reasonable standard of living . . . that is not excessive," *and* "after consideration of all the circumstances [the judge] finds the case to be an abuse" of the Code. Obviously, such litigation, particularly when based on these subjective standards, would be inefficient and costly—it would require added court time, additional judicial decisions, and the payment of extra legal fees. Moreover, under H.R. 3146, a judge would be prohibited from a finding of abuse if the debtor's income was less than $60,000 *even if the debtor could repay all of his or her debts.*

In sum, we believe that H.R. 3150 would implement a needs-based bankruptcy relief system efficiently and effectively. Without systematic needs-based bankruptcy relief, such as that contained in H.R. 3150, the U.S. bankruptcy system will continue to be arbitrary, wasteful and fundamentally unfair to the great majority of consumers who pay for the system but do not use it. Unless this flaw is addressed, controversy surrounding consumer bankruptcy will intensify, not diminish.

TWO MYTHS

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Finally, I would like to take a moment to address a couple of myths that you are likely to hear repeated, possibly today and certainly in the coming months. One is that bankruptcy reform legislation is unnecessary because the system is not broken. Some will claim that credit cards are the real cause of the explosion in personal bankruptcies, and that restricting the availability of credit through credit cards would solve this nation's bankruptcy crisis. I understand that for many this is a tempting and popular position, but it is false. The evidence simply does not support such a contention.

Instead, let's look at the facts. More than 96% of credit card accounts pay as agreed, and only about 1% end up in bankruptcy. Moreover, bankcard debt represents less than 16% of total debt on the average bankruptcy petition and, according to a Federal Reserve Board survey last year, credit cards account for a mere 3.7% of consumer debt—hardly large enough figures to be the cause of the bankruptcy crisis.

Another popular myth is that credit grantors are intentionally offering credit willy-nilly to people who cannot handle it. Once again, this contention simply is not true. Card issuers use highly sophisticated and expensive "prescreening" underwriting techniques, which involve consideration of as many as *hundreds* of factors about a consumer, to ensure that consumers who receive "pre-approved" offers of credit have a demonstrated ability and willingness to repay their debts.

Let me tell you specifically how we do it at MBNA. MBNA is the second largest lender through credit cards in the world. We receive an application from every customer, pull a full credit report on that customer, and do a debt-to-income analysis. We call back over 20% of the customers to develop additional information. A credit analyst will then make a decision to approve or decline the account. If the account is approved, a risk rating is applied and, in many cases, a senior lender sign-off is also required. We believe we are making the right decision every time. The majority of bankruptcies in our file are on customers who have been on the books for more than three years and have had some significant change in their financial condition. Less than 5% of our bankruptcies occur in connection with accounts that have been opened within the past twelve months.

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The fact is, the overwhelming majority of Americans use credit wisely and successfully. Americans use their cards to pay at the gas pump, the grocery store and literally millions of other places. With the advance of on-line security systems, consumers are increasingly using their cards to conduct business and make purchases over the Internet. And credit has made opportunities available for millions of Americans who might not otherwise have had them, across a huge range of income levels.

In addition, the lending industry spends millions of dollars every year on education programs designed to help consumers use credit wisely. The bankcard industry works particularly closely with the more than 1,200 Consumer Credit Counseling Services offices around the country, which help many thousands of consumers get control of their finances and repay their debts. We are proud of the lending community's far-reaching efforts to inform, educate and assist consumers.

Once again, I want to thank you for the opportunity to appear before you today. Please let me know if we can be of any further assistance to the Subcommittee or its staff.

Mr. **GEKAS.** We thank the witness. And we turn to the lady from Harrisburg. You may proceed, Janet.

STATEMENT OF JANET KUBICA, CHIEF EXECUTIVE OFFICER, POSTMARK CREDIT UNION, HARRISBURG, PA

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Ms. **KUBICA.** Good morning, Chairman Gekas and other members of the subcommittee. I'm Janet Kubica, CEO of POSTMARK Credit Union in Harrisburg, Pennsylvania. And I appreciate the opportunity to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions, and my credit union, in particular.

I'm speaking on behalf of the Credit Union National Association which represents over 11,000 State and Federal credit unions nationwide. We are very pleased that this subcommittee is holding hearings today on the important issue of consumer bankruptcy and, in particular, H.R. 3150.

POSTMARK is a $24 million federally insured credit union. Its 4,300 members are primarily postal service employees and their families working in the Harrisburg area. Currently, we have over $14.5 million in loans to our members, and that's $6.5 million in car loans, more than $5 million in home-secured loans, $2 million in personal loans, and, in addition, we've issued 1,000 credit cards for another $1 million.

Everyone is aware of the continuing record of bankruptcy filings. Credit unions are quite concerned with the steady increase of bankruptcy filings nationwide in the last few years because they have seen a similar increase in the number of credit union members who file.

Preliminary data from the credit union call reports to the National Credit Union Administration show that credit unions had approximately 246,000 filings in 1997, which is an increase of 16 percent of over 1996 levels. The 1996 levels were 35 percent higher than the 1995 figures. CUNA estimates that more than half of all credit union losses in 1996 were bankruptcy related and those bankruptcy losses in 1997 will exceed $775 million.

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At POSTMARK, bankruptcy filings and losses have shown a steady increase since 1994, which you can see from the attachment to my written statement. The losses to the credit union really have increased. Our losses in 1994 due to bankruptcy, were almost $3,000 but in 1997, these losses increased to $66,000, which is a 2,000 percent increase.

POSTMARK is a careful lender. We scrutinize loan applications and carefully determine that the applicant is credit worthy before extending credit. We examine credit reports, verify income, and see that a reasonable debt-to-income ratio is maintained by the borrower. We routinely monitor our credit cards and do not make any across-the-board increases to the credit limit. We educate our members about alternatives to bankruptcy. We offer credit counseling to our members and encourage them to come to the credit union for help if they are experiencing financial difficulties. We refer members to the local consumer credit counseling agency, however, counseling, we certainly recognize that there are instances in which bankruptcy may be the only alternative for our members, and the way for them to get the needed fresh start.

Because we are a not-for-profit cooperative financial institution, losses to the credit union have a direct impact on the entire membership because of a potential increase to loan rates or decrease in interest on savings accounts, therefore, we have a policy that if a member causes a loss to the credit union, services to that member, aside from maintaining a regular share account, will be withheld.

We're beginning to see that some members do not care if they cause a loss and are denied service because they believe they can get it elsewhere, even if they pay higher rates. We're seeing more surprise bankruptcies. We've tightened our credit policies as a result of the number of bankruptcies at the credit union. We do annual reviews of our signature lines of credit. We check credit reports and use credit scoring. If a member is experiencing financial problems and mentions bankruptcy, staff trained in credit counseling contact that member and let the member know that the credit union is there to help them through their financial difficulties.

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Let me tell you why we are especially supportive of a provision of your bill. We hired a bankruptcy lawyer to challenge two of our 1996 bankruptcies. In one case, a working couple filed a chapter 13. Their schedule did not show one of them was earning significant overtime. They even denied overtime during a sworn deposition, even though subpoenaed payroll records showed overtime and a joint monthly income of $4,500. These members owed $30,000 to the credit union, $14,000 was discharged and a secured vehicle was crammed down to $13,000.

In the other case, we challenged a plan where we believed the debtor could make more payments. Our attorney fees for these two cases were over $5,800 and, yet, in March 1998, the credit union still has not received any payment from the creditors' plans.

Let me say just a few words about the National Bankruptcy Commission. Credit unions were very actively involved during the review of the bankruptcy system. Credit unions attended the meetings, participated as panelists and wrote over 120 letters. In general, CUNA was disappointed in the consumer bankruptcy recommendations adopted by the Commission. In particular, we believe the Commission erred in not adopting a needs-based bankruptcy recommendation. However, we are pleased that several commissioners did urge such a recommendation in a minority report.

Again, let me say I'm pleased that your holding these hearings today. Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that needs-based bankruptcy presents the best opportunity to achieve this important public policy goal.

Happily, there are bills in both the Senate and House that offer this, and we encourage you to push for passage of such bills before Congress recesses in the Fall. CUNA supports the needs-based approach.

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Thank you. I will be happy to answer any questions.

[The prepared statement of Ms. Kubica follows:]

PREPARED STATEMENT OF JANET KUBICA, CHIEF EXECUTIVE OFFICER, POSTMARK CREDIT UNION, HARRISBURG, PA

Good morning, Chairman Gekas and other members of this subcommittee. I am Janet Kubica, CEO of POSTMARK Credit Union in Harrisburg, Pennsylvania, and I appreciate the opportunity to be here to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions—and my credit union in particular. I am speaking on behalf of the Credit Union National Association (CUNA), which represents over 11,000 state and federal credit unions nationwide. We are very pleased that this subcommittee is holding hearings today on the important issue of consumer bankruptcy and in particular, H.R. 2500 and H.R. 3150.

POSTMARK is a $24 million federally-insured credit union. Its 4,300 members are primarily U.S. Postal Service workers and their families in the Harrisburg area. Our members take advantage of the credit that we offer. Currently we have over $ 14.5 million in loans to our members—that's over $6.5 million in car loans, more than $5 million in home-secured loans, and almost $2 million in personal loans. In addition, we have issued 1,500 credit cards for another $1 million.

Everyone is aware of the continuing record of bankruptcy filings—which exceeded 1.4 million in 1997—a 19% increase from 1996 filings. It is anticipated that the filings for 1998 will go higher. Credit unions are quite concerned at the steady increase in bankruptcy filings nationwide in the last few years because they have seen a similar increase in the number of credit union members who file. Preliminary data from credit union call reports to the National Credit Union Administration show that credit unions had approximately 246,000 filings in 1997, which is an increase of 16% over 1996 levels. And, the 1996 filings were 35% higher than the 1995 figures.

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CUNA estimates that more than half of all credit union losses in 1996 were bankruptcy-related and that those credit union bankruptcy losses in 1997 will exceed $775 million.

At POSTMARK bankruptcy filings and losses have shown a steady increase since 1994. In 1994 we had 7 members who filed for bankruptcy, in 1995 there was dip to 3, and then in 1996 it rose again to 9, and hit 16 in 1997. A significant number of our bankruptcies are Chapter 7, which cause the greatest loss.

As the number of member bankruptcies has increased, so too have the losses to the credit union. Our losses in 1994 due to bankruptcy were only $2,923, but in 1997 these losses had increased to $65,720—an increase of over 2,000%. This information on the number of filings and on the credit union's bankruptcy losses is attached to my testimony.

POSTMARK is a careful lender. We cannot afford to be otherwise. We do a good job with scrutinizing loan applications and carefully determining that the applicant is creditworthy before extending credit. We examine credit reports, verify income, and see that a reasonable debt-to-income ratio is maintained by the borrower. We even look at the applicant's disposable income to determine that the applicant can make the payments. We routinely monitor our credit cards and do not make any across the board increases to the credit limit. Students can apply for a credit card, but we encourage a co-signer and set the credit limit at no more than $500.

We also try to educate our members about alternatives to bankruptcy. We offer credit counseling to all our members at any time and encourage them to come to the credit union for help if they are experiencing financial difficulties. We tell the members about this service in our newsletter and other publications. Examples of these are attached to my testimony. We refer members to the local Consumer Credit Counseling Service as well. However, even with financial counseling we certainly recognize that there are instances in which bankruptcy may be the only alternative for members and the way for them to get the needed "fresh start."

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Credit unions clearly recognize the value of financial counseling for their members. According to a recent CUNA bankruptcy survey, 70% of credit unions counsel financially troubled members at the credit union. A similar percentage of credit unions may also refer members to an outside financial counseling organization, such as the Consumer Credit Counseling Service, and many do both.

Because we are a not-for profit cooperative financial institution, losses to the credit union have a direct impact on the entire membership due to a potential increase to loan rates or decrease in interest on savings accounts. Therefore, we have a policy that if a member causes a loss to the credit union, services to that member, aside from maintaining a share account, will be withheld. Most credit union members take this seriously and continue to reaffirm on their credit union loans. However, we are beginning to see that some members do not care if they cause a loss and are denied service because they believe they can get it elsewhere—even though it may be at a higher rate. We are also seeing more "surprise" bankruptcies, where the member is a long-time member and is current on his or her debt at the time the bankruptcy petition is received.

We try to be proactive in combating the number of bankruptcies at the credit union and have tightened our credit policies to do that. We do annual reviews of our signature lines of credit. We check credit reports and use credit scoring. If a member is experiencing financial problems and mentions bankruptcy to us, we immediately notify staff who are trained in credit counseling to contact that member and let the member know that the credit union is there to help them through the financial difficulty. We started doing this because otherwise the member may file for bankruptcy even in cases where there is an ability to repay. When a member files for bankruptcy, we attend the 341 hearing, where creditors are permitted to question the debtor.

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We hired a bankruptcy lawyer to challenge two of our 1996 bankruptcies. In one case, a working couple, who are credit union members, filed a Chapter 13 in November 1996. However, they did not show on their schedule that one of them was earning significant overtime. They even denied any overtime during a sworn deposition—even though the subpoenaed payroll records showed overtime and a joint monthly income of $4,500. These members owed $30,000 of unsecured and secured debt to the credit union. An unsecured amount of $14,000 was discharged, and the secured vehicle was crammed down to $13,000 in the plan. In the other case, again we challenged a plan where we believed the debtor could make more payments. Our attorney fees for these two cases were over $5,800—and yet in March 1998 the credit union still has not received any payment from either debtor's plan. Challenging a debtor's plan can be costly and delay payment from the plan. This is a reason why we support the provision in H.R. 3150 that the debtor provide tax returns, pay stubs, and other proof of income. Certainly that overtime would have been shown on the pay stub!

The National Bankruptcy Review Commission filed its report with Congress on October 20, 1997, and credit unions were very actively involved during the commission's review of the bankruptcy system—as can be seen from the references to them in that report. Credit unions were in attendance at almost all of the commission's public meetings, participated as panelists at many of the meetings, and wrote over 120 letters to the commission. A credit union person also testified before the commission in December 1996 as CUNA's representative of the National Consumer Bankruptcy Coalition. In general, CUNA was disappointed in the consumer bankruptcy recommendations adopted by the commission in a 5–4 vote. In particular, we believe the commission erred in not adopting a needs-based bankruptcy recommendation that a debtor who can repay at least part of his/her debts should be required to do so. However, we were pleased that several commissioners did urge such a recommendation in a minority report. Credit unions were also disappointed that the commission recommended eliminating the reaffirmation of unsecured debt and greatly limited the possibility of reaffirming debt—after credit unions had been especially vocal about the benefit of reaffirmations both to the credit union and to the members who can thus continue to obtain reasonable credit.

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Again, let me say that I am pleased you are holding this hearing today. Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that "needs-based bankruptcy" presents the best opportunity to achieve this important public policy goal. Happily, there are bills in both the Senate and the House that offer a needs-based approach, and we encourage you to push for passage of such bills before Congress' fall recess. CUNA supports the needs-based approach that is contained in both H.R. 2500 and of H.R. 3150. We are pleased that the Grassley-Durbin bill, S. 1301, contains a needs-based provision. However, we prefer the approach of H.R. 3150 as a fairer, more certain, less litigious alternative. CUNA does not support H.R. 3146.

CUNA has endorsed both H.R. 2500 and H.R. 3150 with their needs-based approach to consumer bankruptcy. We are pleased that H.R. 3150 also contains a "Debtor's Bill of Rights" and a pilot program for consumer education. This bill attempts to strike a balance between making bankruptcy laws fairer and helping consumers avoid or better manage their debt. This is consistent with the primary concerns of credit union members. However, we believe that more emphasis could be placed on education. The CUNA Bankruptcy Subcommittee recently reported that "[e]ducation was found as one of the most promising strategies to consider in attempting to reverse the trends in bankruptcy." Credit unions have found that educating their members about credit and how to use it can be an effective deterrent to filing for bankruptcy. Some may require that a member, who has had previous financial difficulties, have sessions with a credit counselor before any new credit can be extended. Other credit unions, in addition to educating their members, are getting involved in their communities through teaching sessions about credit in local junior high and high schools. CUNA hopes to embark on a nationwide consumer education campaign in the future to help consumers avoid the pitfalls of bankruptcy altogether.

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Thank you. I will be happy to answer any questions.

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Mr. **GEKAS.** Yes, thank you very much. We turn to our final witness on this panel, Mr. Kosturko.

STATEMENT OF WILLIAM T. KOSTURKO, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, PEOPLE'S BANK, BRIDGEPORT, CT, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. **KOSTURKO.** Thank you, Mr. Chairman. Mr. Chairman and members of the subcommittee, thank you very much for your invitation to testify today. I'm pleased to be here. My name is Bill Kosturko, and I'm executive vice president and general counsel at People's Bank, headquartered in Bridgeport, Connecticut. People's is the largest independent bank in Connecticut and we're also the 25th largest credit card issuer in the United States. Today, I'm representing America's Community Bankers, which is a national trade association that serves the savings and community bankers and related business firms of this country.

While ACB members have diverse strategies based on consumer financial services, on housing, and on community development, all of our members are touched by the Bankruptcy Code. The ACB believes, Mr. Chairman, that the bankruptcy system that we have today is fundamentally flawed because, as has been so often stated this morning, it allows the complete discharge of the current debts of persons who have the ability to repay at least a portion, and in certain cases, a significant portion of their financial obligations.

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We believe that the most appropriate way to eliminate the current bankruptcy problems, is to amend the existing Code so that it provides protections for those individuals who really need help. And, for this reason, ACB is a strong advocate of the concept of a needs-based Bankruptcy Code.

One thing that I might mention, in our home State of Connecticut, there's an example that lends support to the arguments of Mr. Cutler earlier this morning, with respect to a need for a system that brings about uniformity and objectivity. Often the chapter 13 and chapter 7 differences are highlighted; by the speakers here this morning, they've been mentioned. I think it's important to know that although across the country 70 percent of the consumer bankruptcy cases are handled in chapter 7, while 30 percent are handled in chapter 13, in the U.S. bankruptcy court in the State of Connecticut, 93 percent of those cases are handled in chapter 7 and only 7 percent are handled in chapter 13, so we don't have a uniform system across the country in that respect.

But in addition to a needs-based bankruptcy system, there are certain other reforms to the Bankruptcy Code which we believe ought to be made. Although my testimony outlines them in more detail, some examples are: banning multiple filings by debtors; allowing creditors with claims of less than $5,000 to attend meetings with a debtor without the current requirement that the creditor be represented by counsel at those meetings; the elimination of cram downs of secured residential real estate liens, allowing creditors to seek payment from solvent co-debtors when the primary debtor has filed a bankruptcy petition; and, finally, providing a uniform national standard for the exemption of household goods.

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ACB recommends these changes to the Bankruptcy Code in an effort to re-calibrate the equities of the consumer bankruptcy system in our country. We recognize, however, that the concept of equity contains an implicit expectation that both parties to a credit transaction—both the borrower and the lender—will act reasonably and responsibly. For that reason, ACB supports continued rigorous enforcement by bank regulators of supervisory standards designed to maintain prudent loan underwriting standards by banking institutions.

Community banks are closely supervised by an extensive bank regulatory mechanism that monitors and supervises credit extension criteria and examines the institutions to ensure that they are in compliance with appropriate credit underwriting standards. These standards include lending limits, loan underwriting guidelines, and credit worthiness standards. These standards must be maintained.

But to reiterate ACB's principal thrust, the lending community is supporting the needs-based approach to bankruptcy incorporated in H.R. 3150 and H.R. 2500. ACB believes that these bills will help to reduce the subsidy that's inherent in our present bankruptcy system to those who use the bankruptcy process as a financial planning tool rather than as a last resort.

As was noted earlier, last year $40 billion of consumer debt was discharged in bankruptcy. Each dollar of that sum that was unnecessarily and inappropriately discharged represents an increase in the cost of credit for those millions of Americans who wake up each day and work hard to meet their financial obligations.

Mr. Chairman, ACB believes that today's system is unfair to those Americans.

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Thank you very much for the opportunity to express our views, and I'm happy to answer any questions.

[The prepared statement of Mr. Kosturko follows:]

PREPARED STATEMENT OF WILLIAM T. KOSTURKO, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, PEOPLE'S BANK, BRIDGEPORT, CT, ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Good Morning, Mr. Chairman and members of the Subcommittee. My name is Bill Kosturko. I am Executive Vice President and General Counsel of People's Bank in Bridgeport, Connecticut which is a member of America's Community Bankers. I am appearing here today on behalf of America's Community Bankers. America's Community Bankers is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees and 15,000 offices. ACB members have diverse strategies based on consumer financial services, housing and community development.

People's Bank is a large but community-based savings bank with $7.2 billion in assets and 90 branches. In 1997, People's Bank originated more than $715 million in residential real estate loans. People's Bank makes three out of every 10 mortgage loans in Bridgeport, and is also the leading mortgage lender in all of Connecticut. We are, in addition, the leading mortgage lender to low- and moderate-income groups. People's has a longstanding commitment to providing mortgage and consumer finance to the inner-city. In addition, we operate a large consumer credit card business with a managed portfolio of more than $2.5 billion. Accordingly, bankruptcy-related losses in both secured and unsecured lending are a matter of great concern to our institution.

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Let me begin by commending the Chairman for holding these timely hearings. As you are aware, Mr. Chairman, the number of bankruptcies continue to rise even in this strong economy. In 1997, for example, bankruptcies reached an all time high of 1.3 million. More than $40 billion in consumer debt was eradicated through bankruptcy last year—losses that are inevitably passed on to all consumers, resulting in a hidden tax of $400 for every American family. The losses from bankruptcy have placed major burdens on community banks, especially those with large consumer and credit card operations.

ACB believes that the bankruptcy system is fundamentally flawed because it allows the discharge of the current debts of persons who have the ability to pay at least a portion of their obligations. The costs of these bankruptcies are borne by all borrowers, and most severely affect lower income borrowers who are least able to pay the debts of others. We believe that the most appropriate way to eliminate the existing bankruptcy problems is to amend the bankruptcy code so that it provides protection for those individuals who really need help.

The most equitable methodology for reform is to erect a bankruptcy system that provides for relatively easy discharges for those who are truly unable to repay, and requires the remainder of the debtors in bankruptcy to repay their debt obligations to the extent possible. Bankruptcy should be the last resort, not an initial response to financial difficulty. If the bankruptcy code is structured so that filing bankruptcy and receiving a discharge becomes too easy, the bankruptcy system will encourage debtors to file for bankruptcy as soon as they incur any significant financial difficulty. The code should instead encourage alternatives such as credit counseling and payment arrangements. We cannot allow bankruptcy to become routine for people who borrow with no real commitment to repay.

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The current bankruptcy code encourages debtors to view bankruptcy as a financial management tool rather than a last resort. Bankruptcy should offer equitable relief for debtors, particularly when they face dire circumstances that often create obligations beyond their ability to pay. Lenders must also recognize that extensions of credit must be made under prudent guidelines.

General Concerns

Community bankers are faced with a number of problems emanating from the existing bankruptcy code. The resolution of these problems includes: (1) incorporation of a needs-based bankruptcy system; (2) elimination of the multiple filings provisions; (3) deletion of mandatory creditors' counsel provisions; (4) reexamination of the cram down provisions; (5) refinement of the co-debtor automatic stay; (6) provision of some uniformity in the household goods area; and (7) provision of some adjustment in existing Chapter 13 plans.

Needs-Based Bankruptcy

ACB believes that the principal problem with the existing bankruptcy code is that debtors who have the ability to repay all or a portion of their debts are not required to do so. They are nevertheless able to receive a discharge in Chapter 7 (liquidation) and maintain many of their assets in the process even though their future earnings may be substantial and remain unimpaired.

Therefore, ACB believes that changes should be made to the code to address this problem. All consumer debtors should be required to initially file in Chapter 13. The bankruptcy court would then determine whether the debtor has sufficient income to pay any portion of his or her debts. If the debtor has the capacity to pay all, or a portion of his or her debts, he or she would remain in Chapter 13 and a repayment plan would be established. If the court determines that the debtor is unable to pay any of his or her debts, the debtor would then be transferred to Chapter 7 and his or her debts would be discharged.

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A fresh start approach—involving a total discharge of debt obligations—should be reserved for those genuine cases of personal or financial adversity (e.g., accumulation of medical expenses) where repayment is truly impractical. The needs-based bankruptcy approach has been largely incorporated in H.R. 2500, H.R. 3150, and S. 1301. ACB generally supports all of these legislative initiatives.

H.R. 3150 (which incorporates the consumer bankruptcy provisions of H.R. 2500) is a particularly strong legislative vehicle for bankruptcy reform. We believe that the consumer bankruptcy provisions in this bill are well balanced and fair. In addition, the provisions relative to small business, single asset cases, direct appeal and bankruptcy tax issues strike such universal themes that they may well be embraced by a majority of the parties affected by bankruptcy code.

However, we have some serious concerns with respect to H.R. 3146, especially the provisions that would punish lenders for extending credit to consumers who are "overloaded" with debt. Creditors should certainly attempt to make loans only to consumers who have the ability to repay. It is only rational to do so. The bankruptcy code is not the appropriate vehicle for determining whether credit was properly extended.

Multiple Filings

Certain debtors now elect to file their bankruptcy petitions in Chapter 13. This chapter is sometimes referred to as the "wage earner's plan" because it is contemplated that the debtor will attempt to pay all or a portion of his or her debts over a three-to-five year period. In turn, the debtor will receive an automatic stay which bars creditors from proceeding against the debtor in connection with any of his or her debt obligations and which ultimately results in a discharge of these obligations.

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Unfortunately, this process is frequently abused by debtors. In many instances, a debtor will file in Chapter 13 and never make any subsequent payments under the proposed payment schedule even though the debtor continues to enjoy the benefits of the automatic stay. Under the current procedure, the creditor must generally wait until the trustee dismisses the debtor's petition before proceeding against the debtor. Once the petition is dismissed, the debtor may refile almost immediately in Chapter 13 or Chapter 7 and the process begins again.

Meeting of Creditors and Equity Security Holders

Section 341 of the bankruptcy code provides that, within a reasonable time after a petition for relief is filed, the United States Trustee shall convene and preside at a meeting of the creditors. The bankruptcy code specifies that the bankruptcy judge may not attend or participate in the proceeding. The debtor appears during the meeting and gives responses under oath to the creditors' interrogatories. A creditor may file a complaint to bar discharge of a debt after the section 341 meeting.

In connection with claims of $5,000 or less, creditors must be represented by counsel. Understandably, it is expensive to retain counsel in an effort to obtain repayment of small claims. In many instances, the bankruptcy attorney's fee makes it unfeasible to pursue a substantial volume of the small claims.

Therefore, a significant portion of claims of $5,000 and under are not challenged by creditors beyond the Section 341 meeting and are therefore forfeited because of cost constraints. The small claims representation issue results in large aggregate losses, especially for credit grantors catering principally to small accounts. These claims add significantly to our member institutions' total bankruptcy-related costs.

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Accordingly, we suggest that the bankruptcy code be amended to provide that creditors may pursue these claims, with or without legal counsel, throughout the bankruptcy proceeding, including proceedings against debtors with obligations of $5,000 or less. This modification to the bankruptcy code would restore some degree of equity to Section 341 meetings and subsequent proceedings.

Cram Downs Revisited

Prior to the Supreme Court decision in *Nobelman* in 1993 and the Bankruptcy Reform Act of 1994, secured lenders faced substantial uncertainty with respect to the cramming down or the diminution of the value of their secured claims in bankruptcy. During this period, many bankruptcy courts routinely reduced the value of a creditor's secured lien to an amount equivalent to the market value of the collateral (at the time of bankruptcy) and designated the remaining value as unsecured. However, the Supreme Court in the *Nobleman* case concluded that the cram down procedure was improper with respect to the debtor's primary residence. The Court specified:

Petitioners propose to reduce the outstanding mortgage principal to the fair market value of the collateral, and, at the same time, they insist that they can do so without modifying the bank's rights as to interest rates, payment amounts, and (other) contract terms. . . . That appears to be impossible. The bank's contractual rights are contained in a unitary note that applies at once to the bank's over-all claim, including both the secured and unsecured components. Petitioners cannot modify the payment and interest terms for the unsecured component, as they propose to do, without also modifying the terms of the secured component.

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In addition, the Bankruptcy Code of 1994 applied the *Nobelman* holding to Chapter 11 proceedings. Since 1994, however, certain bankruptcy courts have started to reinterpret both *Nobelman* and the reference in the 1994 Bankruptcy Reform Act. At the district court level, some courts have ruled that, under certain circumstances, the secured lien on residential real estate can be crammed down. Therefore, we believe that the cram down language from the *Nobelman* case, as well as other germane language, should be incorporated specially into the bankruptcy code to clearly prohibit cram downs of secured residential real estate liens.

Furthermore, ACB believes that second trusts and other liens related to a debtor's principal residence should be accorded the same treatment that the Supreme Court provided for first liens in the *Nobelman* case. As alluded to above, the Court determined that these liens could not be reasonably partitioned into secured and unsecured portions without inappropriately modifying the terms of the secured component. We believe that the same rationale is applicable to second trusts and other liens related to a debtor's principal residence. Therefore, second trusts and other junior liens should not be subject to cram downs.

Moreover, the bankruptcy code, as well as a number of federal and state statutes, have accorded the borrower's principal place of residence special treatment and home ownership has constantly been promoted over the years as a national policy objective. Any limitations placed upon the financing component of the debtor's principal residence by the bankruptcy code complicates existing housing finance arrangements and thereby adversely impacts the affordability of housing.

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Co-debtor Automatic Stay

The bankruptcy code extends the benefits of the automatic stay achieved in Chapter 13 to co-debtors. More specifically, Section 1301 provides that a creditor may not act, commence, or continue any civil action to collect all or any part of a consumer debt from an individual who is liable on such debt with the debtor, unless the case is closed, dismissed, or converted to a case under Chapter 7 or 11. Section 1301 makes an exception for an individual who became liable on the debt or secured by the debt in the ordinary course of such individual's business.

When a debtor files a bankruptcy petition, the automatic stay prohibits creditors from proceeding against the co-debtor in an attempt to collect the underlying debt obligation, even though the co-debtor has not filed a bankruptcy petition. The co-debtor may be quite solvent or may, as a matter of fact, be a multimillionaire.

It should be noted that when the co-debtor signs the underlying debt obligation, he or she is aware of the assumption of joint and several liability and the possibility, under certain circumstances, of becoming the sole obliger to the credit grantor. Section 1301 insulates the co-debtor from contractual obligations that he or she undertook freely. ACB believes it is inappropriate for an individual who has not sought the protection of the bankruptcy code to vitiate his or her contractual obligation.

Further, it is conceivable that the primary debtor could surrender his or her interest in the collateral so that the co-debtor could, in addition, have actual possession of the collateral and continue to use it without making any payments while the automatic stay is in effect. This clearly produces an inequitable result. Therefore, the bankruptcy code should be amended to provide that the automatic stay is lifted with respect to a co-debtor when the Chapter 13 plan is confirmed. This amendment would not, in any way, adversely impact the rights of the debtor in bankruptcy; however, it would permit the credit grantors to pursue their contractual and other remedies against the co-debtor under applicable law.

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Household Goods: Exemptions and Lien Avoidance

Section 522 of the bankruptcy code should be amended to provide a new definition of "household goods" to make it consistent with the definition of this term in the Federal Trade Commission's Credit Practices Rule. In addition, the federal exemption set forth at Section 522(d)(3) should be amended to be consistent with the new definition of "household goods" in order to provide uniformity in those states which permit debtors to make an election between federal and state exemptions. Finally, the reference to "household goods" in Section 522(f)(2), which permits debtors to avoid a judicial or a nonpossessory, nonpurchase-money lien on household goods, should be amended to conform with the new definition.

Accommodating Defaults in Plan Payments

A debtor's confirmed Chapter 11 or Chapter 13 plan should represent equitable "recontracting" of the debtor's obligations with his or her creditors. It should reflect the debtor's best efforts and also protect the creditor's interest so that the creditor will receive more than in a liquidating bankruptcy. Section 1326 of Title 11 specifies that the debtor must "commence making the payment proposed by a plan within 30 days after the plan is filed," and Section 1302(b)(5) requires the trustee to "ensure that the debtor commences making timely payments" under Section 1326 of the code. In addition, Section 1307(c)(4) states that a case may be dismissed or converted based on the debtor's failure to maintain the payment plan. Due to a variety of factors, however, debtors are sometimes unable to maintain regular and prompt plan payments. A large percentage of confirmed Chapter 13 cases are ultimately dismissed, mostly for nonpayment. The bankruptcy court should have the power to reexamine and refashion plans consistent with fluctuations in the debtor's income.

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Credit Card Issues

It has been suggested by some observers that the issuance of credit cards by lenders is a major cause of bankruptcy. This suggestion ignores the fact that more than 96 percent of credit card holders pay their bills as agreed, and only one percent ever end up in bankruptcy. In addition, bank credit cards represent less than 16 percent of total debt on the average bankruptcy petition.

Of course, lenders also have responsibilities to underwrite consumer credit accurately. ACB believes that lenders should extend credit only when there is a reasonable expectation that the borrower can repay the debt obligations in good faith and in a timely manner. As noted above, however, we oppose H.R. 3146 (the Conyers-Nadler bill) because it attempts to limit a creditor's claim in bankruptcy based on a retrospective analysis of the creditor's underwriting practices.

Credit Quality and the Role of Supervision

Balanced against changes to the bankruptcy code necessary to establish proper incentives for discharge of debts within a debtor's ability to pay, ACB supports continued rigorous enforcement by bank regulators of supervisory standards designed to maintain prudent loan underwriting standards. These standards are essential to maintain the safety and soundness of the banking system. The potential for emerging problems connected with consumer credit quality, often involving non-bank lenders, is best addressed by ensuring that appropriate credit policies are followed.

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The necessary statutory and regulatory apparatus currently is in place to oversee credit standards and direct corrective action through the supervisory process where warranted. ACB believes that the banking regulators have been especially mindful of their obligations in this regard, and have indicated that credit standards will be maintained at appropriate levels throughout the business cycle. We encourage this Subcommittee to continue its strong oversight role as it monitors these ongoing efforts by the regulators.

Community banks are supervised closely by an extensive bank regulatory mechanism that monitors and supervises credit extension criteria and examines the institutions to make certain that they are in compliance with applicable credit extension policies. For example, some of the bank regulatory and operational guidelines provide:

lending limits—Federally chartered banks and thrifts generally follow the national bank standard codified in the Office of the Comptroller of the Currency's regulation at 12 CFR Part 32 providing for a per borrower lending limit of 15 percent of an institution's capital and surplus and an additional 10 percent if totally secured by readily marketable collateral. Savings associations have additional flexibility to finance domestic housing or for other loans, generally mortgages, up to $500,000. In addition, many states have established loan to one borrower limits.

loan underwriting guidelines—Loan underwriting standards, such as the interagency guidelines for real estate lending, address the overall creditworthiness of a borrower. For example, see the Office of Thrift Supervision's (OTS) real estate lending regulations at 12 CFR Part 560.

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creditworthiness standards—Banks and thrifts obtain credit reports and evaluate other data to determine a borrower's creditworthiness in terms of debt load and ability to repay. This standard procedure ensures safety and soundness and prudent underwriting standards.

Furthermore, the OTS examination guide specifically instructs examiners to scrutinize extensions of credit by the institutions it regulates. For example, the OTS manual (a portion of which is attached) provides that a savings association's loan policy should: (1) approve and service loans on a safe and sound basis; (2) serve the legitimate needs of the community; (3) address the servicing, collection and charge-off of loans; and (4) be reviewed periodically by the board of directors to ensure that the policy remains appropriate as market conditions change.

The OTS examination procedures also specifically mandate that the regulated institutions maintain precise credit underwriting standards. Each institution must establish and maintain prudent credit underwriting practices that:

are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;

consider the nature of the markets in which loans will be made:

consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;

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establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;

take adequate account of concentration of credit risk; and

make certain that loans are appropriate to the size of the institution and the nature and scope of its activities.

Conclusion

ACB believes that the propriety of loan underwriting has been thoroughly covered by the regulatory agencies. Therefore, it would be wholly inappropriate to limit a institution's subsequent claim in the bankruptcy courts based upon some initial loan underwriting criteria. The historical propose of the bankruptcy code has been to examine the present condition of the debtor and make a determination as to "what is his or her current financial posture"—not whether the debtor should have managed his or her financial resources properly or whether the creditors with whom the debtor has a relationship erred in developing credit underwriting models. We do not believe that this fundamental concept behind the bankruptcy code should be altered.

ACB is grateful to you, Mr. Chairman and other members of the Subcommittee, for the opportunity you have provided us to make our views known with respect to various facets of bankruptcy.

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Mr. **GEKAS.** Yes, we thank the witness. We believe that in some degree, our bill, H.R. 3150, does address the cram down problem and does address the multiple filings problem, to which you referred. If you have additional critiques of our bill as they relate to those issues, we'd like to have a memorandum from you. But we think we touch upon it adequately. We may be egotistical about that, so you let us know.

Mr. **KOSTURKO.** Thank you, Mr. Chairman. We will do that.

Mr. **GEKAS.** Ms. Cosgrove, we also believe that in H.R. 3150 we address the automatic stay problem to which you referred.

Ms. **COSGROVE.** Yes, sir, you do.

Mr. **GEKAS.** Are you satisfied with the context of the bill as we have tried to address that problem?

Ms. **COSGROVE.** Yes we are, thank you.

Mr. **GEKAS.** Well, that's good. Gee, we're making progress here.

Ms. Kubica, the one thing that I'm a little bit ignorant about—many things, but this one, in particular—personal loans, you say, in addition to credit cards, are part of the portfolio that is presented to an applicant for credit in your establishment. Is that correct?

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Ms. **KUBICA.** That's correct.

Mr. **GEKAS.** Did the personal loans result in a lot of bankruptcies, or just the credit card portion, or combination?

Ms. **KUBICA.** At our credit union, the bankruptcies are both the unsecured personal loans and credit cards. We make personal loans to help people, being the type institution that we are. And, for the most part, most of them pay them.

Mr. **GEKAS.** Yes, that interests me because we hear the attacks against H.R. 3150 based on the credit card system, but here we have an instance where the personal loan, and the other example I gave, the "mom and pop" grocery store, are also in the mix of extending credit.

Ms. **KUBICA.** And you could apply that same concept to our credit union, and they are personal loans.

Mr. **GEKAS.** I thank the lady. Mr. Gleason, you stated something that I think is valuable to us, that the bankruptcies that you have experienced have seemed to come in large measure from those who are current——

Mr. **GLEASON.** That's correct.

Mr. **GEKAS** [continuing]. In their obligations to you.

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Mr. **GLEASON.** That is correct.

Mr. **GEKAS.** I draw an inference from that, that they seek bankruptcy as another way of managing their own financial statuses rather than as a last resort. That's proof of the pudding, it seems to me.

Mr. **GLEASON.** I agree with that, but it also prevents us to work with that customer, to counsel the customer, to come up with, perhaps, another repayment plan, if you will, or see if we can help them with whatever difficulties they're having.

When you get blind-sided, and you can't even talk to the customer, you know, it kind of ties your hands.

Mr. **GEKAS.** Mr. Hammonds, one of the bricks that is being thrown at the H.R. 3150 concept is that the credit card issuers somehow send the credit cards directly to the debtor who, the next moment, can use that credit card. Is there much of that at all, or is it applications for credit cards that people receive?

Mr. **HAMMONDS.** Yes, Mr. Chairman. It is not permissible by law to send out unsolicited credit cards so what, in fact, most people are getting are applications which they then have to fill some information out, and many times, they're approved or declined. There are some pre-approved applications, but all of those, to my knowledge, are run through a credit bureau report to make sure people have good credit before they're sent a credit card.

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Mr. **GEKAS.** Notwithstanding that is against the law, do you have any rumors or evidence to the effect that some do issue cards directly?

Mr. **HAMMONDS.** I have not heard of anyone in years issuing an unsolicited credit card.

Mr. **GEKAS.** Mr. Gleason.

Mr. **GLEASON.** I received two unsolicited credit cards in 1967; the first two credit cards that I had received. I think the law was passed in 1969 prohibiting that, and——

Mr. **GEKAS.** Since then——

Mr. **GLEASON.** There wasn't a bankruptcy problem in the 1960's, but there seems to be today.

Mr. **GEKAS.** Since then you have not received any?

Mr. **GLEASON.** That is correct.

Mr. **GEKAS.** And you've not gone bankrupt?

Mr. **GLEASON.** That is also correct. [Laughter.]

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Mr. **GEKAS.** General Heitkamp, we believe that in some respect that in H.R. 3150 treats the problem of notice more succinctly than the current law. And if you have further suggestions about how to affect notice so that the government of your State will know who's going bankrupt and for how much and for what reason, we'd like to help in that regard.

Ms. **HEITKAMP.** Mr. Chairman, thank you, and we will submit additional testimony as your deliberations progress. There's a great deal more detail in my comments, in my prepared——

Mr. **GEKAS.** Yes, we have your prepared statement, and it will be part of the record, but I don't want my ego to run away with me and say that we have treated the question of notice adequately in H.R. 3150. We believe we've treated it, but we don't know whether the patient will die, so if you will help us——

Ms. **HEITKAMP.** Mr. Chairman, that's correct, and we will be meeting during this week, the attorneys general, and considering a resolution. I'll be talking to the others of my counterparts and colleagues throughout the country and I'm sure you'll be getting more detail on our views and reviews of your bill.

Mr. **GEKAS.** We thank you. And with that, I yield the customary 5 minutes to the gentleman from New York.

Mr. **NADLER.** Thank you, Mr. Chairman. I'd like to ask Attorney General Heitkamp the following.

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The 1973 Commission on Bankruptcy Laws wrote as follows:

"Business debtors are not subject to any limitation to 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 the amount of their investments and corporate assets. To force unwilling wage earners to devote their future earnings to payments of past debts smacked to some as debt peonage, particularly when business debtors could not be subject to the same kind of regimen under the act. That's at page 158 and 159 of their report."

Now, my question is, do you believe, given that observation by the 1973 Commission on Bankruptcy, that we need to reexamine the manner in which businesses insulated from personal responsibility, and if not, why should we treat American families so much more harshly than we treat some of the financially reckless corporate raiders of the last few years? [Laughter.]

Ms. **HEITKAMP.** It's an interesting question. I think when you look at what, in fact, has been our experience, I could not say that our experience in North Dakota has been that one is treated worse than the other, and, as a result, we have greater injury to——

Mr. **NADLER.** Excuse me, the point is——

Ms. **HEITKAMP** [continuing]. If we——

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Mr. **NADLER** [continuing]. Of course, that business leaders are insulated personally from liability, from whatever wreckage they cause by the corporate veil——

Ms. **HEITKAMP.** Congressman——

Mr. **NADLER** [continuing]. Whereas people are not.

Ms. **HEITKAMP.** Congressman——

Mr. **NADLER.** Excuse me.

Ms. **HEITKAMP.** Frequently in State law and State taxation law, there is personal obligation, as I'm sure you're familiar with—withholding tax liability—traditionally corporate officers would be responsible for any withholding that was not remitted. There is a number of exceptions to the rule that you're stated. I think that it presupposes that the whole idea of the corporate veil is done strictly to limit liability.

I think that very many of our small corporate entities in North Dakota feel very attached to their corporation and, in fact, suffer economic injury, continue to put personal resources into their corporation, as their corporation is having financial difficulty. And so I think it would be a broad, sweeping statement to say that somehow corporations are less responsible as a result of the bankruptcies protections that they receive, than an individual who may be also seeking that protection.

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Mr. **NADLER.** Thank you. Mr. Hammonds, we have heard repeatedly today that the push for mandatory chapter 13 for the needs-based bankruptcy, so-called, for, forcing people into chapter 13 as opposed to chapter 7, is a response to the recent phenomenon of skyrocketing bankruptcy rates and caused allegedly by bankruptcy losing its social stigma. Would you agree with that?

Mr. **HAMMONDS.** I believe that the social stigma issue has changed as it pertains to bankruptcy, and that is part of the cause of the over 1.3 million citizens last year filing bankruptcy in——

Mr. **NADLER.** But you would agree that the reason we're seeing this push is that there's been, in the last few years, in the 1990's, a very large increase in the number of personal bankruptcies, and that's what caused, perhaps, by, among other things, the loss of social stigma, and that's what behind the necessity, the perceived necessity for this change.

Mr. **HAMMONDS.** That is part of it, yes.

Mr. **NADLER.** If that is the case, why has Congress been repeatedly asked by the credit card industry for similar changes for 30 years? And at least since the 1973 Commission which was asked the same thing, before the recent upsurge in bankruptcies?

Mr. **HAMMONDS.** Well, I think, in the credit card business, we always lend on a person's ability to repay based on their income, and, as I said, their ability to repay. The bankruptcy system doesn't today, and has not, addressed that. So, a bankruptcy system that's built on asset-based lending does not work for the credit card industry, so I think the credit card industry has always wanted that kind of change to be made.

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Mr. **NADLER.** Let me ask you a different question. Do you have the ability to check how much debt a potential borrower already has, before you issue the credit card?

Mr. **HAMMONDS.** Yes, sir, we do.

Mr. **NADLER.** And do you have the ability to check the income stability of debtor?

Mr. **HAMMONDS.** Yes, sir, we do.

Mr. **NADLER.** Well, let me ask about the story, then, that appeared in the January 7 "Wall Street Journal." It says, "This family deserves much credit though why isn't exactly clear." You may have heard of this story; let me summarize it. It's about Mrs. Peggy Boeker of Delmar, California. According to the "Journal," "All told, in 1997, the Boeker family was offered $4,923,000 in credit. That includes only offers that mailed to the Boeker family home in Delmar not separate offers mailed to the three adult Boeker children at their own homes. Leading the pack is Mrs. Boeker herself. Though she's currently without an income, she's personally been offered more than $2.5 million in credit."

Do you think that these lenders acted responsibly?

Mr. **HAMMONDS.** Well, Congressman, an offer of credit is not the same as an extension of credit. We mail applications to people all the time; we don't know all the facts about those people. They fill out the application, they send it back to us, we pull credit reports, we do debt-to-income analysis, we call them to develop additional information, and then, in our case, we wind up approving about 35 percent of all customers that apply to us.

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There's a big difference between getting that offer and the actual extension of credit. We are in a very, very competitive business, and there a lot of mailings, but that is not an extension——

Mr. **NADLER.** So you send a lot of mailings offering credit to people you would have no intention of extending the credit to?

Mr. **HAMMONDS.** Well, we don't know, Congressman, you know, there is not a way up front, to know about everybody's financial circumstances. We, for example, can't know what your income is before we gave you that offer of credit, so we send you an application——

Mr. **NADLER.** Did you check—before you send me an application, would you check with a credit agency?

Mr. **HAMMONDS.** Not necessarily. About 50 percent of the offers that go out today from the bank card industry, someone runs through a credit bureau first; and about 50 percent go out without that kind of information. So, there are various ways to do that but, generally, what we do is send an application and then do a complete credit check when that application comes back in.

Mr. **NADLER.** Thank you. I see my time has expired.

Mr. **GEKAS.** Yes. Well, we've learned a great deal from this panel and we're grateful for the testimony. We hope that you will be available for any future inquiries that we might make as we move this legislation along the path. Thank you very much.

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The next panel now will begin to take their places at the witness table.

Nicholl J. Russell, a senior technical support professional at Gateway 2000. She obtained an associate of science degree at Neddleton Career College in 1996. In 1992, Ms. Russell, on advice of counsel, filed for bankruptcy relief under chapter 7. She's here to explain her experience as a chapter 7 debtor, and how she later reorganized her financial affairs without having to resort to bankruptcy, with the use of credit counseling. We welcome you.

We have with us, also, James Ike Shulman, director and legislative committee chair of the National Association of Consumer Bankruptcy Attorneys. Mr. Shulman received his undergraduate degree from the University of Wisconsin in 1972, and his J.D. from Santa Clara University School of Law in 1984. In 1992, he helped to found the National Association of Consumer Bankruptcy Attorneys. He has served as the Association's first president from 1992 to 1996. Mr. Shulman is a bankruptcy practitioner; he files 200 to 250 chapter 7 and chapter 13 bankruptcy cases per year.

We have with us as well, Henry Sommer, supervising attorney at the Consumer Bankruptcy Assistance Project and of-counsel to the law firm of Miller, Frank & Miller, of our neighboring Philadelphia in Pennsylvania. Mr. Sommer received his A.B. degree from Harvard, magna cum laude, and his J.D. degree from Harvard Law School, cum laude. He is the author of numerous treatises on consumer bankruptcy law and practice, and is a contributing author to "Collier on Bankruptcy." Mr. Sommer is a member of the Federal Judicial Advisory Committee on Bankruptcy Rules, and the National Bankruptcy Conference. He's also a fellow of the American College of Bankruptcy, the American Law Institute, and a former member of the Federal Reserve Board's Consumer Advisory Council. In addition, Mr. Sommer has served on the faculty of numerous continuing legal education programs.

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Matthew J. Mason, assistant director, United Auto Workers-General Motors, the Legal Services Plan of that institution, and on behalf of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America-UAW. Since 1995, Mr. Mason has been the Assistant Director of the United Auto Workers-GM Legal Services Plan. He's responsible for 21 offices located in southeast Michigan, New York and Tennessee. In addition, he chairs the Bankruptcy Work Group for the UAW legal services plan. Mr. Mason received his B.A. degree with distinction from the University of Michigan in 1968. He then served in the United States Army as a first lieutenant and, thereafter, he obtained his J.D. degree cum laude from the University of Michigan Law School. Mr. Mason is active in numerous professional and community activities.

We thank the panel for appearing. We begin by telling them, as we did before, that their written statements will become a part of the record, without objection. And that your testimony will be restricted to 5 minutes plus.

Ms. Russell can begin.

STATEMENT OF NICHOLL J. RUSSELL, SIOUX FALLS, SD

Ms. **RUSSELL.** Good morning. My name is Nicholl Russell and I am from Sioux Falls, South Dakota. I want to thank you, Mr. Chairman, for inviting me to testify today. It really is a great honor.

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I come before you today to share my first-hand experience with our nation's bankruptcy laws and to tell you why I think it is so important for you to make changes to the current system.

In 1992, I found myself in a desperate situation. I had two small children, I was in the middle of a divorce, I had medical bills that were piling up. I found myself with about $55,000 in debts and waitressing job that paid just over $3 an hour plus tips. Creditors were calling me at home and at work, looking for payments that I simply couldn't make. I didn't know what to do.

So, I opened the local phone book and called a bankruptcy attorney. We met at his office and he asked me to write down on a yellow pad how much I owed and to which creditors. That was it. I paid my fee and went home.

Not long afterwards, I received a letter in the mail saying that my bankruptcy petition had been approved and all my debts had been erased. I never saw the inside of a courtroom; I never spoke to a judge. No one ever asked me for a tax return or a pay stub.

It wasn't until later that I realized exactly what I had done. I remember my lawyer telling me that bankruptcy would be on my credit record for 7 to 10 years, but I didn't really know what that meant. I had trouble getting credit anywhere. I was even turned down when I tried to open a checking account. I was refused a job when the interviewer found out that I had bankruptcy on my record and I even had trouble finding an apartment to rent. I had no idea bankruptcy would have such an immense impact on my life. People really look down on you after they find out that you filed for bankruptcy.

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But the worse thing about the bankruptcy process was that it didn't teach me a thing. By early 1996, I was right back into financial trouble with several thousand dollars in debt. But I knew I couldn't file for bankruptcy again so soon after filing the first time. Fortunately, I had heard about a local consumer credit counseling office. I went to talk to one of the counselors and within one hour I felt the weight of the world had been lifted off my shoulders. She put me on budget, arranged for repayment over time with my creditors, and taught me how to manage my own finances.

I'm proud to say that I'm well on my way to completing the consumer credit counseling program. I have a good job and I've paid off nearly all of my debts. I'm teaching my three children as much as I can about financial responsibility so that when they grow up, they'll never have to be in this situation.

Based on my experience, I'd like to share with just a couple of ways I think the bankruptcy system could be improved. Representative Gekas, I want to thank you for introducing the Bankruptcy Reform Act of 1998. I believe H.R. 3150 is a very important bill for all consumers and debtors.

When I filed for bankruptcy, I needed immediate relief from all of my debts. I had very little income and no way to pay what I owed. Chapter 7 was the right place for me. But I'm not sure that's true for everyone. I think if you have a good income and you could repay some of what you owe, then you should have to do that.

I'm not surprised that some people get more relief than they need. When I filed, no one verified my income or my debts, they just took my word for it. For me, bankruptcy was the last resort, and that's what it should be. But my experience proved to me that is didn't matter how much debt or how much income I had; I could have had my debts erased regardless.

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But the part of the bill that I feel most strongly about is the education section. When I saw an attorney about filing for bankruptcy, all he talked about was how easy it would be to wipe away all my debts in chapter 7. He never even mentioned chapter 13, and he certainly never mentioned anything about consumer credit counseling.

I believe it is imperative that the laws require attorneys or the bankruptcy court to tell debtors about their options, both within bankruptcy and outside of bankruptcy, such as consumer credit counseling.

Finally, I understand that this bill sets up a pilot program of financial training for individuals who file bankruptcy. I highly recommend this.

As I said, I learned nothing from going through bankruptcy and just started repeating my mistakes. Until I went to Consumer Credit Counseling Service, no one had ever taken the time to teach the first thing about managing my finances. Without CCCS, I don't know what would have happened to me or my kids.

Fortunately, things are working out for me, and I know that my kids will never have to suffer the way that I did. But I'm the lucky one. Few people receive the kind of help I did, mostly because they're not aware that it exists.

I urge you to pass legislation that makes financial management training a part of the post-bankruptcy process.

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Members of the committee, from what I understand about H.R. 3150, it will ensure that the people who really need complete relief from their debts, get it. And it will teach people a lot more, both about their choices when they file and about how to manage their money after they file. That seems right to me. I urge you to pass H.R. 3150 as soon as you can so that we can all benefit from the better bankruptcy system.

Thank you very much.

[The prepared statement of Ms. Russell follows:]

PREPARED STATEMENT OF NICHOLL RUSSELL, SIOUX FALLS, SD

Good morning, my name is Nicholl Russell and I am from Sioux Falls, South Dakota. I want to thank you, Mr. Chairman, for inviting me to testify today. It really is a tremendous honor.

I come before you today to share my first-hand experience with our nation's bankruptcy laws and to tell you why I think it is so important for you to make changes to the current system. In 1992, I found myself at the end of my rope. I had two small children, I was in the middle of a divorce, I had medical bills that were piling up. I found myself with about $55,000 in debts and a waitressing job that paid just two dollars and thirty cents an hour plus tips. Creditors were calling me at home and at work, looking for payments that I simply could not make. I didn't know what to do.

So I opened the local phone book and called a bankruptcy attorney. We met at his office, and he asked me to write down on a yellow pad how much I owed to which creditors. That was it. I paid my fee and went home. Not long afterwards, I received a letter in the mail saying that my bankruptcy petition had been approved and all my debts had been erased. I never saw the inside of a courtroom, I never spoke to a judge. No one ever asked me for a tax return or a pay stub.

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It wasn't until later that I realized exactly what I had done. I remember my lawyer telling me that bankruptcy would be on my credit record for seven to 10 years, but I didn't really know what that meant. I had trouble getting credit anywhere, and I was even turned down when I tried to open a checking account. I was refused a job when the interviewer found out that I had a bankruptcy on my record and I even had trouble finding an apartment to rent. I had no idea that bankruptcy would have such an immense impact on my life. People really look down on you after they find out that you have filed for bankruptcy.

But the worst thing about the bankruptcy process was that it didn't teach me a thing. By early 1996, I was right back into financial trouble with several thousand dollars in debts—but I knew I couldn't file for bankruptcy again so soon after filing the first time. Fortunately, I heard about a local consumer credit counseling office. I went to talk to one of the counselors and within one hour I felt that the weight of the world had been lifted off my shoulders. My counselor put me on a budget, arranged for repayment over time with my creditors, and taught me how to manage my own finances. I am proud to say that I am well on my way to completing the consumer credit counseling program. I have a good job, I've paid off nearly all my debts, and I am teaching my three children as much as I can about financial responsibility, so that when they grow up, they'll never have to go through what I did.

Based on my experience, I'd like to share with you just a couple of ways that I think the bankruptcy system could be improved. Representative Gekas, I want to thank you for introducing the Bankruptcy Reform Act of 1998. I believe H.R. 3150 is a very important bill for all consumers and debtors. When I filed for bankruptcy, I needed immediate relief from all my debts—I had very little income and no way to pay what I owed. Chapter 7 was the appropriate place for me. But I'm not sure that's true for everyone. I think if you have a good income and could repay some of what you owe, then you should have to do so.

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Frankly, I'm not surprised that some people get more relief than they need. When I filed, no one verified my income or my debts—they just took my word for it. For me, bankruptcy was the last resort, and that's what it should be. But my experience proved to me that it didn't matter how much debt or how much income I had—I could have had my debts erased regardless. I just don't think that makes sense.

But the part of the bill I feel most strongly about is the education section. When I saw an attorney about filing for bankruptcy, all he talked about was how easy it would be to wipe away all my debts in Chapter 7. He never mentioned Chapter 13. And he certainly never mentioned anything about consumer credit counseling. I believe it is imperative that the laws require attorneys or the bankruptcy court to tell debtors about their options, both within bankruptcy and outside of bankruptcy, such as consumer credit counseling.

Finally, I understand that this bill sets up a pilot program of financial management training for individuals who file for bankruptcy. I highly recommend this. As I said, I learned nothing from going through bankruptcy, and I just started repeating my mistakes. Until I went to the Consumer Credit Counseling Service office, no one had ever taken the time to teach me the first thing about managing my finances. Without CCCS, I don't know what would have happened to me or my kids. Fortunately, things fell together for me, and I know that my children will never suffer the way I did. But I'm the lucky one. Few people receive the kind of help I did—mostly because they are not aware it exists. I urge you to pass legislation that makes financial management training a part of the post-bankruptcy process.

Members of the Committee, from what I understand about H.R. 3150, it will ensure that the people who really need complete relief from their debts get it. And it will teach people a lot more, both about their choices when they file and about how to manage their money after they file. That seems logical to me. I urge you to pass H.R. 3150 as soon as you can, so that we can all benefit from a better bankruptcy system. Thank you very much.

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Mr. **GEKAS.** We thank the lady for that engaging testimony. We'll submit your testimony to some questioning a little later.

Mr. Shulman.

STATEMENT OF JAMES IKE SHULMAN, ESQ., NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

Mr. **SHULMAN.** Thank you, Mr. Chairman and honorable members of the committee. My name is Ike Shulman, and I am appearing to today on behalf of the National Association of Consumer Bankruptcy Attorneys, or NACBA, as well as a bankruptcy practitioner representing consumers and small business debtors in San Jose, California.

Each year, I file between 200 and 250 bankruptcy cases, divided between chapter 7 and chapter 13 filings. From this experience, I would like to share with you my perspective on who are consumer debtors, as well as the impact that H.R. 3150 would have on them.

First, who are the debtors today, who are these 1.3 million people coming into the bankruptcy court? People I see every day are not much different from the people you see in your community. It could be the realtor down on the corner who suffered a business downturn; the assembly worker who has been laid off from his job for several months; or the couple next door who are separating and don't have nearly enough income now to live apart, support their kids, and still pay their bills. Many clients I see are single mothers, who have struggled for years to stay afloat on one income alone, often with no support, and who just can't make it any longer. Some are older workers who used to have decent incomes but who have been downsized or let go from their jobs due to age. Most of these people would be fairly described as working or middle class Americans.

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While their backgrounds are diverse, these clients share two things in common. First, they've tried virtually everything possible to avoid having to come see an attorney. They used up their personal savings; borrowed from friends and relatives; offered small payments to the creditors, without success; many have tried to take on second jobs. And, in my case, most of the people I see have already gone to the local consumer credit counseling service office to try to work out their debt problems, but they simply don't have enough income to either qualify or keep the payments up.

The second thing my clients have in common is that they share a deep sense of shame in having to file for bankruptcy. Many clients break down and cry during our interviews. Filing for bankruptcy is the last thing they ever wanted to do. Those who claim that the stigma of bankruptcy is gone should meet my clients. They feel terrible, but when they leave my office with the knowledge that there is a solution to their problems today, their relief is profound. I believe that my clients are typical of consumer debtors nationally, based on my conversations with bankruptcy judges, trustees, and attorneys across the country. However, the image of the consumer debtor created by the banking lobby, and which you've heard some of the creditor representatives testify today, bears little resemblance to my clients.

The industry, instead, speaks of large numbers of debtors filing bankruptcies of convenience, and they portray them as cavalier about the filing of bankruptcy. The use of slick marketing slogans and images cannot substitute for the truth. Certainly some anecdotal accounts of abuse can be pointed to in the bankruptcy system, as with any legal system in our country. But such cases are but a tiny percentage of the 1.3 million families filing for bankruptcy relief this last year.

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And where there is abuse, the current Bankruptcy Code provides remedies. I'd like to note that I heard several anecdotes pointed out earlier this morning about debtors doing harsh, wrongful things. The current bankruptcy law, as I understand it, gives creditors remedies for virtually all of those, including the commission of fraud and intentional torts.

And in addition, H.R. 3146, introduced by Congressman Nadler, would strengthen those remedies without harming the overwhelming number of honest debtors in the ways that H.R. 3150 does harm them.

Attached to my statement is a detailed analysis by NACBA of the provisions of H.R. 3150 and their impact on consumer debtors. At this time, I would like to focus on just one of these provisions, and that is the provision that would bar chapter 7 relief and virtually eliminate the chapter 13 option for hundreds of thousands of debtors.

H.R. 3150 would measure a debtor's eligibility for chapter 13 and their ability to pay—eligibility for chapter 7 and their ability to pay in chapter 13, based on applying hypothetical income and living expenses to the debtor.

Such a test would combine phantom income, including temporary support from family members and income from jobs since lost, with expenses which have no connection with the real expenses of the debtor. Far from being needs based, this test would completely ignore the debtor's needs.

Expenses debtors have that would not be accounted for would be housing expenses that are higher than the national average, but may be the norm in their community, child and elder care expenses, church donations and other legitimate expenses unique to individual families.

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After paying these expenses from their actual income, many have no money left to pay their debts and can file chapter 7 today or can file chapter 13 and still be allowed to pay their mortgage.

However, H.R. 3150 would bar this relief for a great number of debtors by attributing income to them which doesn't exist, and ignoring their actual expenses. These people would be left in the impossible position of being barred from obtaining bankruptcy relief while still being unable to pay their debts. They'd face a life of continued creditor harassment, wage garnishments, car repossessions and many more home foreclosures, putting them in the position of being unable to provide food and shelter for their families.

Most dramatically, they would face a future where they can never achieve a fresh start. The social and economic costs of this to our society would likely be enormous. Thank you.

[The prepared statement of Mr. Shulman follows:]

PREPARED STATEMENT OF JAMES (IKE) SHULMAN, ESQ., NATIONAL ASSOCIATION OF CONSUMER BANKRUPTCY ATTORNEYS

SUMMARY OF TESTIMONY

Most consumer bankruptcy debtors are honest hardworking people who no longer have the ability to pay their debts. They have attempted virtually all possible options to avoid filing for bankruptcy. They are deeply ashamed of their financial failure and have resisted bankruptcy because of the stigma they feel. In contrast, the image of debtors rushing to file bankruptcies of convenience created by the banking lobby is false.

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H.R. 3150 would have a damaging impact on honest consumer bankruptcy debtors. It would bar Chapter 7 relief for many, and would make Chapter 13 unworkable for many others. Furthermore, the creation of many more nondischargeable debts would severely erode the fresh start concept inherent in our bankruptcy laws.

Society as a whole would also be damaged by the adoption of H.R. 3150. It would lead to family disintegration, job instability, thousands more foreclosures, and the development of an underground economy for those who cannot survive in the legitimate economy. Finally, H.R. 3150 would lead to banks increasing the marketing and offering of credit to higher risk borrowers who would ultimately be unable to pay their debts.

I. PERSONAL BACKGROUND

Good morning Mr. Chairman and Honorable Members of the Subcommittee. My name is Ike Shulman, and I am honored to be here today on behalf of the National Association of Consumer Bankruptcy Attorneys (NACBA), and as a bankruptcy practitioner representing consumer and small business debtors in private practice over the past twelve years in San Jose, California. I am certified as a Specialist in Consumer and Small Business Bankruptcy Law by the State Bar of California Board of Legal Specialization.

I received my undergraduate degree from the University of Wisconsin-Madison in 1972, and my J.D. from Santa Clara University School of Law in 1984. In 1992, I organized the effort to form the National Association of Consumer Bankruptcy Attorneys to provide consumer debtors with an effective voice in the legislative process. I served as NACBA's first president from 1992 to 1996, and I am currently a NACBA Director and the Chair of NACBA's Legislative Committee. NACBA today has approximately 1,150 members across the nation.

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Neither I nor NACBA has received any federal grant, contract, or subcontract in the current or preceding two fiscal years.

During my years of practice, I have filed 200 to 250 bankruptcy cases per year, divided between Chapter 13 and Chapter 7 cases. From this experience, I would like to share with you my perspective on the impact that H.R. 3150 would have on the people I represent.

II. WHO ARE CONSUMER BANKRUPTCY DEBTORS?

The people who come to my office every day desperate for relief are not much different from the people you see in your community. They could be the realtor down at the corner who has suffered a downturn in his business, the assembly worker whose hours just were cut way back, or even worse, who has been laid off for several months, or the couple next door who are separating and do not have nearly enough income to live apart, support their kids, and still pay their bills. Many are single mothers who have struggled for years to stay afloat on one income alone, often with no support, and who just cannot make it. Some are older workers, who used to have decent incomes, but who have been downsized or let go from their jobs due to age. Most of these people would be fairly described as members of the working or middle class.

While their backgrounds are diverse, these clients share two things in common. First, they have tried virtually everything possible to avoid having to come to see an attorney about bankruptcy. They have used up any personal savings, borrowed from friends and relatives, offered small payments to their creditors (without success), borrowed against their retirement savings, and many have tried to take on second jobs. In addition, most of the people I see have already gone to Consumer Credit Counseling Services to try to work out their debt problems, but they simply don't have the income to qualify or are unable to keep up the required high monthly payments.

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Second, my clients all feel a deep sense of shame in having to file for bankruptcy relief. Many clients break down and cry during our interviews, unable to suppress their overwhelming sense of personal failure. Filing bankruptcy is the last thing they ever wanted to do. Those who claim that the stigma of bankruptcy is gone should meet my clients. They feel terrible, but when they leave my office with the knowledge that there is a solution to their problems, their relief is profound. They suddenly have the realization that they can finally obtain financial stability in their life and have a future.

I believe that my honest and hardworking clients are typical of consumer debtors nationally, based on my conversations with bankruptcy attorneys across the country. However, the image of the consumer debtor created by the banking lobby bears little resemblance to my clients. The industry instead speaks of large numbers of debtors filing "bankruptcies of convenience." The bank lobby also suggests that consumer debtors are manipulative and often use bankruptcies as a financial planning tool. Debtors are portrayed as phoning in their bankruptcies from the local golf course. The use of these slick marketing slogans and images cannot substitute for the truth.

Certainly, some anecdotal accounts of abuse can be pointed to in the bankruptcy system, as with any legal system in our country. But such cases are but a tiny percentage of the 1.4 million families filing for bankruptcy relief this last year. And these few abusers are mostly "high-rollers" who don't fit the definition of consumer debtors by any stretch of the imagination—doctors, lawyers, and movie stars. Where there is abuse, the current Bankruptcy Code provides remedies. And, H.R. 3146, introduced by Congressman Nadler, would strengthen those remedies without harming the overwhelming number of honest debtors.

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III. IMPACT OF H.R. 3150 ON CONSUMER BANKRUPTCY DEBTORS

Attached to this statement is a detailed analysis by NACBA of the provisions of H.R. 3150 and their impact on consumer debtors. Due to time constraints, I would like to focus today on just a few of these provisions and their likely effect on debtors.

A. Bar on Chapter 7 Relief

H.R. 3150 contains a provision limiting a debtor's eligibility for Chapter 7 based on the application of the debtor's income in the past six months to his hypothetical living expenses. Such a test would combine phantom income (including temporary support from family members and income from jobs since lost) with expenses which have no connection with the real expenses of the debtor. Far from being "needs-based", this test would completely ignore the debtor's needs. Many of my clients have legitimate expenses not included in the IRS expense guidelines. These include housing expenses in areas with high housing costs, child and elder care expenses, church donations, and other legitimate expenses unique to individual families. After paying these living expenses, many have no money left to pay debts and can file a Chapter 7 case today. However, H.R. 3150 would bar this relief for a great number of debtors by attributing income to the debtors which does not exist and ignoring their actual living expenses.

Furthermore, the stringent IRS guidelines were designed to protect a government interest (collecting taxes) outside of bankruptcy. Applying these same guidelines to protect and encourage the banking industry's risky lending practices is unjustified, as well as bad economic policy.

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Debtors who would be ineligible for Chapter 7 would be left in the impossible position of being barred from obtaining bankruptcy relief while still being unable to pay their debts. These debtors would face a life of continued creditor harassment, wage garnishments, car repossessions, and home foreclosures—putting them in the position of being unable to provide food and shelter for their families. Most dramatically, they would face a future where they can never achieve a fresh start. The social and economic costs of this to our society, while not addressed by the sponsors of H.R. 3150, will likely be enormous.

B. Chapter 13 Made Unworkable for Most Debtors

Many debtors who now are able to save their homes from foreclosure and cars from repossession, and stop wage garnishments, would be unable to file Chapter 13 under these proposed changes. Similar to the Chapter 7 analysis of income and expenses, a Chapter 13 debtor's "ability to pay" under this bill is *not* based upon the debtor's actual income and expenses (housing costs, child care, etc.). In fact, in cities such as San Jose with housing costs far above the IRS guidelines, most of my clients who are homeowners would not be eligible for Chapter 13 at all. Under H.R. 3150, many of these debtors who need to file Chapter 13 to cure their home mortgage defaults would no longer be permitted to budget enough money to make their current mortgage payments because the bill's income and expense formulas require an impossibly high payment amount to unsecured creditors instead.

The vulnerability of most Chapter 13 debtors during their years of plan payments to income interruption and major unexpected expenses such as car repairs and uninsured medical expenses is borne out by the fact that a large percentage of voluntary Chapter 13 plans do not complete, and those that do usually encounter some complications that require plan modifications. The failure rate for the unrealistic payment plans mandated by H.R. 3150 would cause this failure rate to skyrocket.

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C. Making Many More Debts Nondischargeable Severely Erodes the Fresh Start

H.R. 3150 has several provisions which would make many more debts nondischargeable in both Chapter 7 and Chapter 13 cases. Nondischargeability has historically been reserved for the protection of important governmental interests and for the protection of victims of fraud or other intentional wrongful conduct by the debtor. Today, nondischargeable debts include recent taxes, support obligations, most student loans, criminal restitution and fines, and debts where the debtor committed fraud or other intentional torts.

The banking industry would lower the standard of nondischargeability by eliminating the debtor's intent as a factor, so that most credit card debts would be nondischargeable even where the debtor committed no fraud. H.R. 3150 would replace the fraud standard with a standard which would allow credit card companies to bring nondischargeability suits in bankruptcy simply because a debtor had used his credit card in the hopes of staving off a bankruptcy. Most of my own clients have used their credit cards during times of unemployment while hoping to find a replacement job. Very few of my clients could afford the additional litigation costs which would be incurred in defending these dischargeability complaints.

IV. ADVERSE CONSEQUENCES TO SOCIETY WHICH WOULD BE CAUSED BY H.R. 3150

It is important to note that passage of H.R. 3150 would not only hurt hundreds of thousands of individual debtors as I have described above, but would also create many adverse consequences for our society as a whole.

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With so many more debtors unable to get debt relief, the stresses on families will lead to many more divorces and family disintegration. Job instability will increase as debtors leave jobs to avoid wage garnishments. Many debtors will simply be unable to cope in the legitimate economy and be forced underground. Because Chapter 13 would be so unworkable, thousands of additional homes will be foreclosed without any benefit to the affected creditors.

Creation of many more categories of dischargeable debt will leave large numbers of debtors without a fresh start after bankruptcy, but will result in little if any additional dollars for creditors because such debts are almost never collected.

Finally, H.R. 3150 would encourage the banking industry to make ever more risky loans by removing bankruptcy as a possible alternative for marginal debtors.

Section-by-Section Analysis of H.R. 3150 (Gekas-McCollum-Boucher-Moran) by the National Association of Consumer Bankruptcy Attorneys (NACBA) March 1998
TITLE I—CONSUMER BANKRUPTCY PROVISIONS

Section 101. Needs-Based Bankruptcy

This provision would add a test to determine if a debtor is qualified to file Chapter 7. The debtor's qualification would depend upon a calculation of hypothetical income (based upon all past income received in the six months prior to bankruptcy, including non-taxable income and gifts) and subtracting hypothetical expenses (based upon rigid IRS allowances). If the debtor has the hypothetical ability, after paying priority and secured debt amortized over five years, to pay at least $50 per month additional, and if that amount will pay at least 20% of the unsecured debt over five years, the debtor *will not be qualified* to file Chapter 7. Only in extraordinary circumstances would actual projected income and expenses of the debtor be taken into consideration. In Chapter 13 cases, the debtor would be required to file a "needs-based analysis" each year to determine whether payments to general unsecured creditors should be increased or decreased.

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This radical provision would prevent hundreds of thousands of honest debtors from obtaining the bankruptcy relief they need and currently receive. In the vast majority of cases, debtors who would be unable to file Chapter 7 would have no actual ability to repay any of their discharged unsecured debt, contrary to the false claims of the banking lobby. Huge numbers of debtors would be disqualified from Chapter 7 simply because housing costs in their locale exceed the guidelines. Many others would fail the test because they have child care or elder care responsibilities, or have religious convictions which impose financial obligations on them. Many more debtors would be disqualified because they simply could not afford to litigate their legitimate expenses before the bankruptcy court. In addition, numerous other debtors would be unjustly disqualified because they had received some temporary support from their families before the bankruptcy. These ineligible debtors would be left in the impossible position of being barred from obtaining bankruptcy relief while still being unable to pay their debts. These debtors would face a life of continued creditor harassment, wage garnishments, car repossessions, and home foreclosures—putting them in the position of being unable to provide food and shelter for their families. These social and economic costs to our society, while not addressed by the sponsors of H.R. 3150, will likely be enormous.

In addition, the cost of administering such an exhaustive review of debtors' income and expenses would be exorbitant. Chapter 7 Trustees would be required to greatly expand their staffing in order to conduct these reviews. Chapter 13 Trustees would also face greatly increased costs, from the initial budget review as well as the mandated annual "needs-based analysis" for each year of the plan. These administrative expenses would likely reduce the dividends to unsecured creditors, rather than create the "bonanza" touted by the banking lobby. Finally, bankruptcy courts would be overburdened by the massive increase in litigation over budget issues.

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Section 102. Adequate Income Shall Be Committed To A Plan That Pays Unsecured Creditors

This provision would establish a formula for calculating and distributing payments to creditors in Chapter 13 cases. Priority debts would be paid in even monthly payments over the full term of the plan. Secured claims are paid similarly, in even monthly payments over the full term of the plan. Secured claims would include future interest in addition to the payoff amount (total of remaining payments). The bill is unclear about the treatment of arrears on home loans, likely creating adequate protection problems in many cases and thereby preventing many debtors from saving their homes from foreclosure, as they can do under the current Chapter 13.

After conducting a hypothetical net monthly income analysis similar to that under Chapter 7 (subtracting hypothetical expenses and stretched-out payments for priority and secured debts from the hypothetical income of the debtor), the remaining amount of the debtor's hypothetical budget would be paid only to general unsecured creditors. Debtors with income under 75% of the national median family income would be able to propose three-year plans; debtors with income at or above 75% of the national median family income would be required to propose at least five-year plans.

As provided in Section 101, in Chapter 13 cases, the debtor would be required to file a "needs-based analysis" each year to determine whether payments to general unsecured creditors should be increased or decreased.

Many debtors who now are able to save their homes from foreclosure and cars from repossession, and stop wage garnishments, would be unable to file Chapter 13 under these proposed changes. Similar to the Chapter 7 analysis of income and expenses, a Chapter 13 debtor's "ability to pay" under this bill is *not* based upon the debtor's actual income and expenses (housing costs, child care, etc.). The vulnerability of most Chapter 13 debtors during their years of plan payments to income interruption and major unexpected expenses such as car repairs and uninsured medical expenses is borne out by the fact that a large percentage of voluntary Chapter 13 plans do not complete, and those that do usually encounter some complications that require plan modifications. The failure rate for the "involuntary" plans mandated by H.R. 3150 would cause this failure rate to skyrocket. Again, the bank lobbyists claim, without any valid ubstantiation, that debtors have the ability to pay more to creditors. That claim is simply not true.

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Section 103. Definition of Inappropriate Use

As under current law, a debtor's qualification for Chapter 7 relief could also be challenged by a trustee or U.S. Trustee under Section 707(b). In addition, a creditor could bring a motion to deny the debtor relief under Chapter 7, opening up a new means for creditors to harass and attempt to intimidate debtors into paying unjustified settlements to avoid litigation which bankrupt debtors simply cannot afford to fund. Under this bill, a debtor could be denied relief under Chapter 7 if such a bankruptcy were found an "inappropriate use" of the Bankruptcy Code, a murky standard by any analysis; as opposed to the current "substantial abuse" standard or the "abuse" standard proposed in H.R. 3146. Under the "inappropriate use" standard, many truly insolvent debtors would be denied bankruptcy relief on poorly defined grounds and left financially disabled, without any protection from the incessant harassment of abusive creditors, wage garnishments, foreclosures, repossessions, and bank account seizures.

Section 111. Notice of Alternatives

This provision would require the U.S. Trustee to prescribe a Notice of Alternatives to be given to each debtor which describes the relief provided under chapters 7, 11, 12 and 13; and lists nonprofit credit counselling services in the area.

Section 112. Debtor Financial Management Training Test Program

The Director of the U.S. Trustee Program would be required to develop curriculum and materials for a debtor financial management training program and to select three judicial districts for one-year test programs for use with Chapter 7 and 13 cases.

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Section 113. Definitions

This provision would define attorneys as well as non-attorney Bankruptcy Petition Preparers as "debt relief counselling agencies".

Section 114. Disclosures

This provision would require "debt relief counselling agencies" (both attorneys and non-attorneys) to provide certain legal advice to debtors. Contrary to the provisions of current Section 110 which provide effective tools for U.S. Trustees, private trustees, and creditors to stamp out unlawful actions of non-attorneys, this provision would *actually authorize and even require* non-attorneys to give legal advice to the debtor. This provision not only is completely without merit, it would create a serious problem for innocent debtors who would receive erroneous "legal advice" from non-attorneys. In addition, abuses against creditors arising from non-attorney petition preparers would proliferate. These abuses include "eviction defense" bankruptcy mills and fraudulent schemes involving transfers of fractional interests in real property. In contrast, H.R. 3146 contains a provision which would give U.S. Trustees more enforcement tools with which to police the unlawful and fraudulent activities of Bankruptcy Petition Preparers against both debtors and creditors.

Section 115. Debtor's Bill of Rights

This provision includes a series of restrictions on advertising and advice given by attorneys and non-attorneys. Again, this section authorizes non-attorneys to practice law. The substantive limitations imposed by this provision are already imposed on attorneys by state ethical codes and Federal Rule of Bankruptcy Procedure 9011.

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Section 116. Enforcement

This provision would make a contract which violates these disclosure and "Bill of Rights" provisions, *void*, which would hurt consumers by denying them the right to enforce such contracts. It also makes attorneys the guarantors of their clients' cases. For example, if a case were dismissed or converted under §707, even if the attorney had no way of knowing the facts that gave rise to the conversion, the attorney would be required to refund the fee, and might be required to provide unlimited free additional legal services (perhaps to a client who has consistently lied to and failed to cooperate with the attorney). This section also specifically preempts state unauthorized practice of law statutes that would otherwise prohibit the legal advice from non-attorneys required by §114. Any enforcement of these provisions is curiously left to the State Attorney General rather than the U.S. Trustee. State Attorney General offices normally have no interest or expertise in bankruptcy issues, as opposed to the U.S. Trustees' offices.

Section 121. Discouraging Bad Faith Repeat Filings

This section eliminates the automatic stay after 30 days whenever a debtor has had a case dismissed and refiles within a one-year period. The debtor would have to bring an immediate motion to obtain an additional stay, at considerable additional expense. This provision would be most harmful to pro se debtors whose cases are dismissed for errors in filing required documents. Not only would such debtors (who often correct their filings in the second case) be unlikely to be able to bring the required motion, but they would be presumed to have filed in bad faith because inadvertence is deemed to be bad faith. To the extent that there is a real problem of repeat filings, the proposal of the American Bankruptcy Institute consumer bankruptcy steering committee, which included debtor and creditor representatives, is a far more workable solution. Similarly, the National Bankruptcy Review Commission, which extensively analyzed this issue with the help of scores of witnesses including judges and trustees within the bankruptcy system, came up with a much more reasonable proposal which recognized that most second filings are legitimate. A more constructive and narrowly focused approach designed to root out actual abuse while not harming innocent debtors is contained in H.R. 3146.

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This section also provides for *in rem* orders which may grant indefinite relief from the stay for a particular property. Unlike the more reasonable proposal adopted by the National Bankruptcy Review Commission and the American Bankruptcy Institute steering committee, H.R. 3150 would not require a showing that property had been transferred in an attempt to evade the stay, or even a requirement of notice to nondebtor co-owners of the property, such as a spouse who might be living there with the debtor's children. The order could apply to an innocent future homeowner who buys the property 20 years later and subsequently defaults on his or her mortgage. H.R. 3146 addresses this problem without harming innocent debtors.

Section 122. Definitions of Household Goods and Antiques

This provision revives the creditors' attempts to import the restrictive FTC definition of household goods, adopted for a different purpose, into the Bankruptcy Code. It would allow creditors to again coerce reaffirmations by threatening repossession of items that have almost no resale value, but high sentimental or replacement value to the debtor. Based on the FTC definition, creditors in the past have claimed the right to repossess children's swing sets, lawn mowers, children's toys, sleeping bags, family heirlooms, and other similar items. Because there is no market for profitable resale, the right to threaten repossession is the only value which these items have to the creditor—the value of this threat should not be institutionalized as federal policy. These claims have been repeatedly rejected by Congress and the courts in the past.

In contrast with the bankruptcy context, the FTC rule applies even when the debtor has no financial problems. Bankruptcy debtors, almost by definition, are in default and unlikely to be able to afford to replace the property. The leverage associated with a threat of repossession thus goes up substantially.

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Section 123. Debtor Retention of Personal Property Security

In another effort to force reaffirmations, this provision would allow creditors to threaten repossession of debtors' property if they did not either redeem the property by paying its value or reaffirm a debt that is almost invariably significantly greater than the property's value. This provision is guaranteed to exacerbate the Sears-type of problem and encourage other creditors to engage in similar abusive practices.

In addition, this provision places unreasonable time restrictions (within 30 days of the §341 Meeting of Creditors) on effecting either a reaffirmation agreement or redemption of secured personal property. This provision would allow the creditor to repossess the property unless either reaffirmation or redemption were immediately accomplished, both of which normally take some time to negotiate, obtain appraisals, or to obtain a court ordered redemption value.

Section 124. Relief from Stay When the Debtor Does Not Complete Intended Surrender of Consumer Debt Collateral

This provision would give creditors the right to unilaterally determine whether the debtor has met Code requirements regarding secured debts and unexpired leases, and to determine the consequences of such an alleged failure, determinations now reserved for the court. It also misstates the debtor's options with respect to secured debts, ignoring the right to avoid the creditor's lien under section 522(f). It is one more lever for creditors with Sears-type security interests in household goods to threaten repossession and coerce reaffirmations.

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Section 125. Giving Secured Creditors Fair Treatment in Chapter 13

This provision allows a secured creditor to retain a lien on the debtor's property even after its secured claim has been paid, putting the debtor at risk of repossession and foreclosure if thereafter, for whatever reason, the debtor is unable to complete a chapter 13 plan. There is no justification for giving a secured creditor this kind of continuing leverage over the debtor when it has already received the value of its collateral, with interest, under the plan.

Section 126. Prompt Relief From Stay in Individual Cases

This section provides for automatic termination of the stay if the court does not render a final decision within 60 days of the request for relief from stay. Aside from poor drafting, which appears to provide that the stay would be terminated as to all creditors, not just the moving creditor, this amendment is unnecessary. The Code already contains similar language for stays of acts against property. No need for any change has been shown.

Section 127. Stopping Abusive Conversions from Chapter 13

This amendment purports to deal with "abusive conversions from chapter 13." What is the abuse? The amendment eliminates a provision that gives credit for the payments made on secured claims such as car loans to debtors who have attempted unsuccessfully to pay their creditors in chapter 13. The creditor amendment would give no credit for the payments unless the secured and unsecured portions of the claim had been paid in full, which, of course, under other creditor proposals would be impossible until a chapter 13 plan is completed. No evidence of abuse in this regard has ever been offered by creditors.

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Section 128. Restraining Abusive Purchases on Secured Credit

This provision would require a debtor to pay the full balance owed on any secured debt incurred as long ago as six months prior to the bankruptcy, or within two years if a second case is later filed. Although the provision claims to be directed at abuse, the creditor has no obligation to show any abuse. The debtor could have suffered a total disability after the purchase and suddenly had to file a bankruptcy which could not have been anticipated at the time of the purchase. Nonetheless, this debtor's creditor would be able to hold the debtor's property hostage and demand far more than it is worth with the threat of repossession if that amount is not paid. Needless to say, this would severely compound the problem of coerced reaffirmations by creditors like Sears, which claims to take a security interest in everything the debtor purchases, from underwear to nails and screws. It directly undermines the intent of the 1978 Act which adopted provisions to ensure that such unfair leverage could not be exercised based upon household goods necessary to a family that are in fact worthless to the creditor. See, e.g., H.R. Rep. No. 95–595, 95th Cong. 1st Sess. 124 (1977).

Section 129. Fair Valuation of Collateral

This provision reverses the Supreme Court's recent decision in the *Rash* case by valuing property at retail. By so doing, the amendment would give secured creditors a windfall by allowing recoupment for retailing costs they never incur in the chapter 13 process, costs which the Supreme Court specifically held should be excluded from the chapter 13 valuation process. The proposal of the National Bankruptcy Review Commission provides a reasonable mechanism for implementing the Supreme Court decision.

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Section 130. Protection of Holders of Claims Secured by Debtor's Principal Residence

This provision would prevent a debtor from stripping down a debt partially secured by property which includes more than merely a residence, such as an attached rental unit. In addition, if property had been used as a principal residence within six months of the bankruptcy, the debtor would also be unable to strip down the partially secured debt to the value of the property. Separately, this provision would allow real property lenders to postpone and continue foreclosure sales without permission of the bankruptcy court.

In summary, the provision is one more disincentive for debtors to use Chapter 13. Forcing debtors into that chapter while simultaneously undermining its protective provisions seems aimed at punishing rather than promoting the use of payment plans by debtors with financial problems.

Section 141. Debts Incurred to Pay Nondischargeable Debts

This section would give a creditor the right to claim that its debt is a priority debt or a nondischargeable debt if its debt was incurred to pay a priority or nondischargeable debt. One can only imagine the claims of every credit card lender that will argue that, because the debtor incurred credit from that lender, the debtor had money to pay child support, taxes, or other types of non-dischargeable debts. The litigation over tracing problems would be mind-boggling. Similarly, in many cases there would have to be litigation over whether the debt that was paid was a nondischargeable or priority debt to begin with. The section does not address the issue of how to deal with debts that are nondischargeable under section 523(c) only if the creditor to whom the debt is owed raises the issue in the bankruptcy case. Is the creditor that claims that its money paid such a debt bound by the same strictures as the original creditor? The bill appears to give greater rights to the alleged secondary creditor than to the original creditor. And, since debtors do not have the financial ability to litigate these matters, this provision will simply give a green light to every creditor to attempt to coerce reaffirmation by alleging its funds were used to pay nondischargeable debts.

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Section 142. Credit Extension on the Eve of Bankruptcy Presumed Nondischargeable

In the 1980s the credit industry claimed to be concerned about debtors "loading up" on luxury items before bankruptcy. In response Congress passed a provision creating a presumption that certain purchases of luxury items or cash advances of substantial amounts within 60 days before bankruptcy were fraudulent. Having won this victory and having persuaded Congress to go even further in 1994, the creditors have now dropped all pretense of concern about what they originally claimed the problem was.

This section creates a presumption that any credit purchase and any other consumer debt, no matter how necessary or minor, if incurred within a certain time frame, is fraudulent.

The current reality is that the credit industry is constantly claiming that consumers commit fraud, but in real life rarely can convince a court that this is true—generally because the American consumer is, by and large, honest. Therefore, the industry has decided to dispense with the nuisance of having to show any fraud and simply wishes to have Congress presume that all American consumers who file a bankruptcy within 90 days after incurring any debt have engaged in fraud even if there is no indication whatsoever that fraud has occurred. In other words, the presumption would be false in the vast majority of cases and debtors would have to expend litigation costs to overcome it.

Fraud is a serious offense. If words are to have any relation to their true meanings, Congress should not so casually classify millions of American consumers as dishonest and fraudulent. Ironically, the only debtors who would be hurt by such a presumption would be those who were innocent of fraud. Any debtor who actually did seek to run up debts and then avoid them in bankruptcy would simply wait out the 90 days, or whatever period was necessary. Only those debtors who were compelled to file due to an emergency, or were too unsophisticated to even know about the 90 day rule, would be ensnared.

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Section 143. Fraudulent Debts are Nondischargeable in Chapter 13 Cases

This provision would subject a Chapter 13 debtor to expensive and frequently abusive and groundless nondischargeability litigation perpetrated by creditors who only seek nuisance settlements. Currently, an honest debtor can usually be protected from such creditor abuse by filing a Chapter 13 which the court finds to be filed in "good faith."

By adding more exceptions to the Chapter 13 discharge, this provision greatly reduces incentives for debtors to file and complete Chapter 13 plans. The incentives to file Chapter 13 added in 1978 have encouraged a large number of debtors to voluntarily elect Chapter 13 plans over Chapter 7 and these incentives should not be eliminated.

Moreover, by adding these exceptions to discharge, the creditors hope to open the door to the type of litigation they have used to coerce reaffirmations in Chapter 7 cases, so that debtors will continue to be obligated to them after completing a Chapter 13 plan. The number of additional adversary proceedings to determine dischargeability and the resulting burdens on the courts will be enormous.

Section 144. Applying the Codebtor Stay Only When It Protects the Debtor

This provision would lead to conflict among family members with cosigned loans. Current law protects cosigners from creditors' attempts to collect a debt which the other debtor's Chapter 13 plan provides to pay in full. There is no good policy reason for creditors to insist on collecting from the codebtor what the Chapter 13 debtor is paying directly. This also automatically terminate the stay as to personal property leases if the debtor's plan provides to surrender the property.

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The Code currently gives a creditor the right to seek relief from the Chapter 13 codebtor stay if the debtor was really the codebtor on the obligation and did not receive the consideration for the claim. This amendment would allow creditors to simply ignore the stay if they alleged that the debtor did not receive the consideration or if the property securing the debt is not in the possession of the debtor. Thus, for example if a husband-debtor is separated from his nondebtor wife, a creditor could simply repossess a car from the wife notwithstanding the fact that the husband was making payments on the car in Chapter 13. The current statute properly places such decisions in the hands of the court, not creditors, and should not be changed.

Section 145. Credit Extensions Without a Reasonable Expectation of Repayment Made Nondischargeable

This provision would vastly increase the amount of abusive nondischargeability litigation perpetrated by creditors in Chapter 7 cases. The standard for finding a debt nondischargeable would be greatly expanded beyond the current requirement for "actual fraud", and would include any credit card debt incurred without a "reasonable expectation or ability to repay". Many honest bankruptcy debtors borrow well beyond their "ability to repay" without ever knowing it, and at the knowing invitation of the banks. Few debtors realize that it will take as much as 35 years to repay their credit card at the rate of the minimum monthly payment, although the banks are well aware of that fact. It is completely unfair to place blame on the debtor for unwittingly stumbling into such a difficult financial position. Similarly, the debt would be nondischargeable if the debtor did not "take reasonable steps to ensure the accuracy of the [financing] statement", thereby relieving the creditor of any responsibility for analyzing, relying on, or even reviewing the debtor's objective creditworthiness.

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Section 161. Giving Debtors the Ability to Keep Leased Personal Property by Assumption

This provision would prevent the debtor from electing to keep current on the pre-petition lease agreement and thereby be entitled to continued use of the leased property. Lease rejection would occur automatically if the lease is not formally assumed.

This amendment is directed at a problem that does not exist. A lease that is not assumed by the trustee is abandoned to the debtor, and there is no need for the debtor to assume it as this new section provides. The main purpose of the amendment is to give personal property lessors relief from the automatic stay so they may immediately threaten repossession, even if the debtor is current on the lease payments.

Section 162. Adequate Protection of Lessors and Purchase Money Secured Creditors

The debtor would have to make the payments required by the pre-petition contract in addition to the Chapter 13 plan payments until the plan is confirmed. This would put the debtor in the untenable position of being required to make nearly double payments during the early months of the plan. This provision also would require the debtor to insure any personal property securing a loan or lease.

This provision would apply to all claims based upon purchase-money security interests in the debtor's personal property, including the security interests in underwear and other valueless items held by creditors like Sears, as well as security interests that are voidable under the Code. The debtor would have the burden of seeking modification of these payments, a burden few debtors could afford to carry out. These "adequate protection" payments would have to come out of the debtor's minimal allowed living expenses as prescribed by the IRS because all of the debtor's "monthly net income" would be paid only to general unsecured creditors. The section also excuses consumer creditors for violations of the automatic stay and turnover requirements until such payments are made. This could prevent a debtor from recovering a wrongfully repossessed car, causing the debtor to lose his or job and thereby become unable to pay any creditors. This provision of H.R. 3150 entirely undermines that cornerstone of bankruptcy policy which involves providing a breathing space for debtors through an effective automatic stay.

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Section 163. Adequate Protection for Lessors

This provision would allow residential landlords to proceed with state court evictions without requiring bankruptcy court permission. If a debtor is not allowed a short time to re-group immediately after filing a bankruptcy and make arrangements for replacement housing, the debtor may become homeless and jobless and have no ability to pay any of his/her debts. The creditors as a whole would be detrimentally affected by this provision.

Section 171. Extend Period Between Bankruptcy Discharges

A Chapter 7 debtor would be prevented from receiving a second discharge in bankruptcy within ten years of the first one, rather than within six years. A Chapter 13 debtor would be prevented from granting a discharge in a Chapter 13 case filed within five years of a prior bankruptcy discharge. This could have the result preventing a second Chapter 13 case from being filed for 12 years after the filing a prior Chapter 13 with a seven-year plan.

This provision would change the law of almost 100 years. There has been no showing that debtors who received prior discharges are regularly filing new cases six years later, and in fact they are not. And, for example, a debtor who incurred unexpected medical expenses a few years after a prior case could not even attempt to pay those expenses through a Chapter 13 plan. These provisions are just one more effort to make bankruptcy generally less available to debtors who need it and who have done nothing wrong.

Section 181. Exemptions

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This provision would apply the exemption laws of the locale in which the debtor had his/her domicile for the longer portion of the previous year, rather than 180 days.

TITLE II—BUSINESS BANKRUPTCY PROVISIONS

Section 201. Limitation Relating to the Use of Fee Examiners

This provision would prohibit the bankruptcy court from appointing a fee examiner.

Section 202. Sharing of Compensation

Inexplicably, this provision would exempt bar associations from the normal bankruptcy restrictions on fee-splitting.

Section 203. Chapter 12 Made Permanent Law

This provision would repeal the sunset provision currently in Chapter 12 and make it permanent law.

Section 204. Meetings of Creditors and Equity Security Holders

This provision would allow the court to waive the 341 hearing if the debtor has solicited acceptances of the proposed plan prior to filing the case.

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Section 205. Creditors' and Equity Security Holders' Committees

This provision would allow the bankruptcy court to change a Chapter 11 committee membership.

Section 206. Postpetition Disclosure and Solicitation

This provision permits postpetition solicitation of acceptance or rejection of a Chapter 11 plan in certain cases.

Section 207. Preferences

This provision would make payments by the debtor in the ordinary course of business not subject to recovery as preferences. In addition, amounts transferred by, or seized or garnished from a business debtor would not be recoverable unless at least $5,000.

Section 208. Venue of Certain Proceedings

28 U.S.C. 1409 would be amended to restrict actions of trustees against noninsiders regarding nonconsumer debts

under $10,000 to the district court of the defendant's residence.

Section 209. Setting a Date Certain for Trustees to Accept or Reject Unexpired Leases on Nonresidential Real Property

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This provision would allow the trustee up to 120 days to accept or reject unexpired leases on nonresidential real property, but not beyond the date of plan confirmation.

Section 231–253. Small Business Bankruptcy Provisions

These provisions relate to Chapter 11 cases with aggregate noncontingent, liquidated secured and unsecured debts of $5 million or less.

TITLE III—MUNICIPAL BANKRUPTCY PROVISIONS

TITLE IV—BANKRUPTCY ADMINISTRATION

Section 401. Adequate Preparation Time for Creditors Before the First Meeting of Creditors in Individual Cases

This provision would require the first Meeting of Creditors (Sec. 341 Meeting) to occur 60 to 90 days from the bankruptcy filing date, unless otherwise ordered by the court only in unusual circumstances. This change would have the effect of delaying the Meeting of Creditors compared with the current 20 to 40 day (Chapter 7), or 20 to 50 day (Chapter 13) requirement for scheduling such meetings.

Section 402. Creditor Representation at First Meeting of Creditors

This provision would allow consumer creditors to use non-attorney staff to question debtors at Meetings of Creditors in Chapter 7 and 13 cases. This change would make it more difficult for trustees to control the course of Meetings of Creditors, and keep creditors on point. It would also subject debtors to harassment and humiliation perpetrated by unprofessional low-level employees who have no understanding of legal process or the protections of the Bankruptcy Code. This provision would permit activities that constitute the unauthorized practice of law in many states. Regulation of the practice of law is properly a function for the states.

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Section 403. Filing Proofs of Claim

This provision would change the current system of requiring creditors to file proofs of claims in Chapter 7 and 13 cases. This proposal, which imports the "deemed filed" rule of Chapter 11 into consumer cases, fails to understand a basic difference between most Chapter 11 cases and most consumer cases. The typical claims contemplated by section 1111(a) are recorded in the books of a corporate Chapter 11 debtor by trained bookkeepers and other fiscal employees. They may be claims of suppliers or other trade creditors, or various other types of noncontroversial, undisputed claims. It is completely logical to accept as prima facie valid such undisputed claims derived from the books and records of the corporate debtor.

In contrast, very few consumer debtors keep books and records. At best, they have a fairly complete set of their bills. Often, consumer debtor attorneys must obtain title reports or consumer credit reports to ensure that they in fact have a fairly complete list of the consumer's debts. It is a rare case in which the attorney would know the exact amount of most claims on the date of filing. In addition, a deemed filed rule would undermine the integrity of the process.

Chapter 13 trustees would be required to make distributions based upon debtors' estimates of claims that might be confused and inaccurate rather than, as now, based upon sworn proofs of claims filed by creditors who do have professional bookkeepers. The potential for incorrect distributions would increase exponentially. In addition, trustees would undoubtedly be faced with the administrative burden of numerous checks being returned or going uncashed due to inaccurate addresses. The proposal would cause chaos in trustees' offices and greater expense for the system.

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Section 404. Audit Procedures

The Attorney General would set up procedures for auditing the accuracy of petitions and schedules filed in Chapter 7 and 13 cases. The regional U.S. Trustees would contract with third party entities to actually perform the audits. On a random basis, one out of fifty cases would be audited. In addition, every single case in which the debtor's income and expenses vary more than the average from the norm of the district would be audited. This second type of audit would require the regional U.S. Trustee to maintain statistics on the norm of income and expenses, as well as determining the average variance from that norm, in order to be able to identify the large number of cases that would exceed that average variance. A procedure would be established for reporting the results of these audits, which would also be filed with the bankruptcy court. In addition, a procedure would be set up for pursuing debtors for any material misstatement in their schedules.

Section 405. Giving Creditors Fair Notice in Chapter 7 and 13 Cases

This provision would require a debtor's debt schedule and notices to list the account number on the last communication from the creditor or the original contract. Without this account number, the debtor's notice would be ineffective and the creditor would not be subject to the automatic stay or discharge injunction. This change would prevent honest debtors from obtaining any relief on a substantial percentage of their unsecured debts. Many consumer debtors have moved frequently, misplaced loan agreements, and disposed of duplicate collection letters. It would be the rare case where the debtor could be sure to have listed the correct account number. Notices now require the debtor's name, social security number, and address, which together are sufficient for a creditor to locate a debtor in nearly any marginally functional accounting system.

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This amendment would provide opportunities to creditors to claim that their debts were not discharged, and to violate the automatic stay with impunity, based upon minor irregularities in giving notice of the bankruptcy, even if the creditor received actual notice. It requires the debtor's account number to be included in every notice given to a creditor, enormously complicating the process of giving notice and adding to the expense of a case. Many creditors unilaterally change debtors' account numbers and numbers always change when a debt is sold from one creditor to another. Also, many debtors do not always have complete financial records, and this amendment would jeopardize the discharge simply for failing to include the debtor's account number or failing to use an address that was given by the creditor in the original credit agreement, which was usually lost years before. Congress rejected similar language in 1994. Parts of the amendment also make no sense, insofar as they refer to the debtor giving notices that are normally given by the clerk of the court.

Section 406. Timely Filing and Confirmation of Plans in Chapter 13

Inexplicably, this provision seems to lengthen the time for the debtor to file a plan, from the current 15 days (FRBP 1007), to 30 days, after the filing of the bankruptcy petition. In addition, this provision requires that the plan confirmation hearing must occur within 45 days of the filing of the plan. Further, if the plan were filed with the petition, as is common, this provision would result in the confirmation hearing being held before the Meeting of Creditors which, could not be held until 60 days after the petition.

Section 407. Debtor to Provide Tax Returns and Other Information

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This provision would add to the list of documents to be filed with the court by the debtor: all paycheck stubs for the two months prior to filing the case, calculation of projected monthly income, an explanation of extraordinary circumstances relating to income or expenses, statement of reasonably anticipated increase in income or expenses in next year. This proposal would increase the need for storage space in Bankruptcy Court Clerks' offices by at least 100%.

Upon request of any creditor, the debtor would be required to serve the petition and any schedules on that creditor within ten days. The debtor would also be required to provide to the U.S. Trustee complete copies of all tax returns filed by the debtor for the three most recent tax years preceding the filing of the bankruptcy case. The U.S. Trustee would be required to maintain these returns for public review and copying. A Chapter 13 debtor would be required to file annually during the pendancy of the case a new statement and calculation of income and expenses, as well as tax returns.

As a result, it permits creditors to impose significant costs on financially-distressed debtors. Since many consumers do not have copies of past tax returns or pay records, this requirement would also impose additional delay and expenses necessary to obtain these records that most consumers cannot afford to bear. Indeed their cases could be dismissed before the documents can be obtained.

Trustees already have the power to request all of these documents from any debtor and such requests are frequently made. Moreover, any creditor may schedule and conduct a Rule 2004 examination under the current Rules of Bankruptcy Procedure in order to obtain this information.

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Section 408. Dismissal for Failure to File Schedules Timely or Provide Required Information

This provision provides for a delayed procedure for dismissing cases due to incomplete schedules. Currently, a case can be dismissed forthwith, after 15 days from the filing of the case, if all papers are not properly filed with the court. This provision would extend the time during which a defective case would remain open, up to 60 days after the filing of the bankruptcy. The change would also set a time limit of up to 30 days for the debtor's compliance with the requirement to provide copies of tax returns with the U.S. Trustee.

Section 409. Adequate Time to Prepare for Hearing on Confirmation of the Plan

This provision requires the Chapter 13 plan confirmation hearing to be held 20 to 45 days after the Meeting of Creditors—but Sec. 406 of this bill conflicts with this requirement.

Table 1

The above example shows how this bill could require the plan confirmation hearing to be held *before the Meeting of Creditors—undoubtedly, a result unintended by the drafters of this bill.*

Section 410. Chapter 13 Plans to Have a 5-Year Duration in Certain Cases

This provision would require a debtor-family with income of at least 75% of the national median family income for a family of equal size, to propose a plan of at least five years in length. A debtor-family with less than 75% of the national median family income would be required to propose at least a 3-year plan.

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The result would be to require 5-year Chapter 13 plans in almost all cases, nearly doubling the required payments a debtor must make in Chapter 13. Only debtors with income under 75% of the national median income, i.e. those not forced into Chapter 13 by the creditors' mandatory Chapter 13 proposal, could file 3-year plans, which are now the norm. In addition, as discussed above, the use of national median income figures means that debtors with only half of the median income in their own state could be forced to file 5-year Chapter 13 plans.

Expanding plans to five years would also greatly increase the already high failure rate in Chapter 13. Almost any debtor is likely to undergo some period of financial instability in any five year period. In fact, the best predictor of future financial problems is that a debtor has already had one or more periods of financial instability. For example, a debtor who has lost income due to disability is more likely than average to have another period of disability in the future.

Section 411. Sense of the Congress Regarding Expansion of Rule 9011 of the Federal Rules of Bankruptcy Procedure

This provision would result in an expansion of FRBP 9011 to require that an attorney make a reasonable inquiry to verify information in documents filed with the court, whether or not they are signed by the attorney or the debtors. This expansion of the type of conduct that is sanctionable would be unreasonable and impractical. If a debtor's attorney is not signing a document, he/she may have no control over whether it is filed with the court, and may not even be aware of its existence.

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Section 412. Jurisdiction of Courts of Appeals

This provision would allow a direct appeal from the bankruptcy court to the United States Court of Appeals, without requiring the intermediate review by a Bankruptcy Appellate Panel or a U.S. District Court.

Section 441. Improved Bankruptcy Statistics

This provision would require the U.S. Trustee Program to collect and compile a substantial amount of new statistical data which would be taken from the consumer Chapter 7, 11, and 13 schedules.

Section 442. Bankruptcy Data

This provision requires the Attorney General to prescribe forms for trustee's final reports and periodic reports in Chapter 11 cases.

Section 443. Sense of the Congress Regarding Availability of Bankruptcy Data

This provision would express the sense of Congress that bankruptcy court clerks' electronic data should be available to the public on demand.

TITLE V—TAX PROVISIONS

Section 501. Treatment of Certain Liens

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This provision would prevent a bankruptcy trustee from voiding a property tax lien and paying the proceeds of the sale of the asset to higher priority creditors than the holder of the voided property tax lien.

Section 502. Enforcement of Child and Spousal Support

This provision would override, for bankruptcy debtors, state exemptions which protect homesteads from support liens.

Section 503. Effective Notice to Government

This provision would require a debtor to specify the department, agency or instrumentality of the governmental unit which the debtor owes. While this change appears reasonable, it would provide governments a reason to claim that they were not correctly notified even though the noticing defect was of little practical effect to them.

Section 504. Notice of Request for a Determination of Taxes

This change could impose liability for taxes incurred by the estate on a trustee or debtor if the request for a determination of the tax liability was not "made in the manner designated by the governmental unit." Again, taxing agencies could claim technical defects in such requests which could result in the imposition of unfair tax liabilities on innocent parties. See also Sec. 516 of this Bill.

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Section 505. Rate of Interest on Tax Claims

This provision would entitle all tax claims, regardless of their status as secured, priority or general unsecured, to interest at the normal IRS rate. This change would drastically increase the cost of bankruptcies to debtors and decrease dividends to general unsecured creditors by diverting those dividends to pay interest on all tax claims. A large percentage of Chapter 13 plans, under current law, help to rehabilitate the debtors and pay creditors, would be infeasible if this change, alone, were in effect.

Section 506. Tolling of Priority of Tax Claim Time Periods

This provision would toll the 240-day post-assessment period for any time during which the debtor had an installment repayment agreement in place or had made an offer in compromise, and apply a six-month tolling penalty for dismissed cases.

Section 507. Assessment Defined

This provision regarding state tax assessments may either clarify or further confuse the definition of "assessment."

Section 508. Chapter 13 Discharge of Fraudulent and Other Taxes

This provision would prohibit the discharge of taxes in a Chapter 13 case even if those taxes are older than three years, if the return was filed late and within two years of the bankruptcy, or if the tax was assessed by means of a substitute return filed by the taxing agency, or where fraud is asserted by the agency. In addition, many other types of taxes which are priority claims would be made nondischargeable also. This outrageous provision would mean that taxing agencies could essentially "opt out" of the bankruptcy process, refuse to file claims and be paid through the bankruptcy, and then later proceed against the debtor after discharge.

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Section 509. Chapter 11 Discharge of Fraudulent Taxes

This provision relates only to Chapter 11 cases.

Section 510. The Stay of Tax Proceedings

This provision would stay tax court litigation only as to pre-petition taxes.

Section 511. Periodic Payment of Taxes in Chapter 11 Cases

This provision relates only to Chapter 11 cases.

Section 512. The Avoidance of Statutory Tax Liens Prohibited

This provision would, in essence, repeal Sec. 545 by eliminating a trustee's right to avoid tax liens which are unenforceable against bonafide purchasers.

Section 513. Course of Business Payment of Taxes

This provision would require the payment of post-petition property taxes without requiring the taxing agency to file a request for approval of an administrative claim.

Section 514. Tardily Filed Priority Tax Claims

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This provision would allow tardily filed priority tax claims after distribution has commenced or even concluded, up to the court approval of the trustee's final report. This change would create a major problem for trustees who may be required to recover funds already distributed, in order to pay a late-filed tax claim.

Section 515. Income Tax Returns Prepared by Tax Authorities

This provision would make three-year old taxes resulting from a "service-filed return" nondischargeable, but would allow the discharge of a similar return actually signed by the debtor.

Section 516. The Discharge of the Estate's Liability for Unpaid Taxes

The estate would also be relieved of liability for unpaid taxes, under the terms set forth in Sec. 504, supra, of this Bill.

Section 517. Requirement to File Tax Returns to Confirm Chapter 13 Plans

This provision would require a Chapter 13 debtor to file all tax returns due during the previous six years, prior to the Meeting of Creditors. The trustee could continue the Meeting of Creditors for up to 120 days in order for the debtor to file the necessary returns. This change would impose a difficult burden for many debtors to meet, especially considering the spotty work history of many of them. Since taxing agencies are allowed to estimate taxes owed for years in which returns have were not filed by the debtor, a remedy currently exists for, and is utilized actively by taxing agencies.

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Section 518. Standards for Tax Disclosure

This provision affects Chapter 11 cases only.

Section 519. Setoff of Tax Refunds

This provision would allow a taxing agency to offset a post-petition refund for a pre-petition tax year, against a pre-petition tax liability.

TITLE VI—MISCELLANEOUS

Section 601. Technical Amendments

Section 602. Application of Amendments

This bill would apply only to cases filed after the date of enactment.

Qualification Test for Chapter 7 Debtors and Formula for Repayments Under Chapter 13 Pursuant to Proposed H.R. 3150

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[which substitutes for H.R 2500 (McCollum-Boucher)]

QUALIFICATION TEST FOR CHAPTER 7 DEBTORS

Summary: H.R. 3150 would ordinarily prevent a debtor from filing a Chapter 7 if, based upon all income or gifts received by the debtor in the previous six months, the debtor could afford to pay at least 20% of his/her unsecured debt over five years at $50+ per month after subtracting only the IRS budget allowance amounts and hypothetically amortized certain secured and priority debts. This test would not apply to debtors with incomes under 75% of the national median income.

Hypothetical income: The debtor's "current monthly total income" means the average monthly income received within six months of filing bankruptcy from all sources without regard to whether it is taxable income, including any amount paid by anyone other than the debtor (e.g. gifts or temporary assistance provided by family members). [Sec. 101(1) & 101(4)] This ignores the fact that many debtors experience permanent loss of overtime, part-time jobs, unemployment or disability benefits, or are never able to replace a previous higher-paying job.

Hypothetical expenses: Only in extraordinary circumstances would the debtor be allowed to deviate from these allowed hypothetical expenses. [Sec. 101(4)]

1. *Basic expenses:* The debtor's allowed expenses are determined by the IRS schedule of expenses used for offers i n compromise.

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2. *Secured debts:* In addition to the IRS expenses, secured debts such as car loans are accounted for by deducting a hypothetical monthly payment amount assuming the loan is paid over five years, instead of accounting for the actual contract loan payment which would be required to be paid in order to keep the car.

3. *Priority debts:* If the debtor owes back taxes or support, the debtor can deduct a monthly amount calculated by amortizing the priority debt over five years. Of course, this fails to take into consideration that interest and penalties would continue to accrue, and that a five-year amortization excluding interest would not pay off the debt for many, many years and would subject the debtor to wage garnishments and bank account seizures during the five-year period. [Sec. 101(1) & 101(4)]

Formula for determining qualification for Chapter 7

The debtor's hypothetical expenses are deducted from the debtor's hypothetical income. The debtor's remaining hypothetical net monthly income is then multiplied by 60 months to determine the total amount of money which could hypothetically be paid to unsecured creditors. [Sec. 101(1) & 101(4)]

A debtor earning 75% of the national median income or more would not be eligible for a Chapter 7 if that 60-month total of hypothetical net monthly income equals at least 20% of the debtor's unsecured nonpriority debt, and the hypothetical net monthly income is at least $50. [Sec. 101(1) & 101(4)]

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Example:

Hypothetical net monthly payment—$55
Total amount of unsecured nonpriority debt—$15,000
$55 × 60 months = $3,300
$15,000 × 20% = $3,000

Because this debtor could hypothetically (although frequently not, in reality) afford to pay $55 per month, and because 60 months of those payments ($3,300) would exceed 20% of their unsecured debt ($3,000), this debtor would not be allowed to file a Chapter 7 bankruptcy.

FORMULA FOR REPAYMENTS UNDER CHAPTER 13

Summary: H.R. 3150 would ordinarily require a Chapter 13 debtor to pay virtually all of his/her net income (using a formula similar to the Chapter 7 net income analysis) to unsecured creditors *only*, for three to five years. This proposal reverses the priority for payments under the current system to the extent that in most cases priority payments would be stretched over the entire length of the plan, including the two optional years, but the general unsecured claims (e.g., credit card debt) would be paid the entire hypothetical net monthly payment during the early (three to five) years of the plan.

Hypothetical income: The same hypothetical income is used as in the Chapter 7 analysis, assuming the continuation of all prior forms of income and gifts. [Sec. 101(1) & 101(4)]

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Hypothetical expenses: Only in extraordinary circumstances would the debtor be allowed to deviate from these allowed hypothetical expenses. [Sec. 102(3)]

1. T3Basic expenses: The debtor would be allowed similar expenses as in the Chapter 7 analysis above. [Sec. 102(1)]

2. *Secured debts:* In many cases the debtor's budget would not account for the full amount of the regular contract payments on secured debts such as car loans, which the debtor would be required to pay during the months prior to confirmation of the plan. The bill is unclear about how arrears on home loans would be cured, at best curing them over the entire three to seven year period and creating adequate protection problems with many of those loans. This bill would, in many cases, eliminate Chapter 13 as a mechanism for allowing a debtor to cure house arrears and prevent the foreclosure of his/her home, because most lenders would be unwilling to wait up to seven years for the cure of pre-petition arrears. [Sec. 102(1) & 410]

3. *Priority debt:* Priority debts such as recent taxes and child support would be paid in even payments over the full term of the plan (three to seven years). [Sec. 102(1)]

Formula for repayments under Chapter 13:

The debtor's hypothetical expenses are deducted from the debtor's hypothetical income. The debtor's remaining hypothetical net monthly income is earmarked for monthly plan payments to general unsecured creditors only. [Sec. 102(5)]

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1. *Minimum Payments:* All Chapter 13 plans must pay no less than $50 per month on unsecured nonpriority claims (e.g., credit card debts).

2. *A debtor earning up to 75% of the national median income:* This debtor would be required to pay the entire hypothetical net monthly income to unsecured nonpriority creditors (e.g., credit card lenders) for *three* years. [Sec. 102(5)]

3. *A debtor earning more than 75% of the national median income:* The same formula applies except that the debtor would have to pay the entire hypothetical net monthly income on unsecured nonpriority claims (e.g., credit card debts) for five years instead of three years. [Sec. 102(5)]

4. *Increases in debtor's income during the plan:* All increases [or decreases] in the debtor's income during the term of the plan shall go to [or be subtracted from] the payment on unsecured nonpriority claims (e.g., credit card debt), leaving the debtor with no incentive to improve his/her situation. Nor would the debtor be able to accumulate any modest contingency fund for emergencies. [Sec. 102(5)(iii)]

5. *Secured debts such as car loans:* With regard to secured debts such as car loans, the debtor would in most cases be required to continue to pay the full monthly contract loan payment in order to keep the car during the early months of the plan prior to confirmation. The debtor's budget does not allow for such a payment—only the hypothetical monthly amount amortized over the full length of the plan. Accordingly, the additional funds necessary to pay the full contract payment would need to be diverted from the debtor's food budget or other essential item during the critical early months in the plan. [Sec. 162]

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6. *Priority debts such as recent income taxes and past-due child support:* The debtor would pay recent income taxes and past-due child support in equal payments amortized over the full length of the plan.

7. *Nondischargeable debts which are nonpriority:* Certain nonpriority debts are also nondischargeable such as most student loans and child support assigned to government agencies. Such debts would be paid along with credit card debt, and in many cases would leave the debtor owing substantial portions of these nondischargeable debts at the end of the plan.

Mr. **GEKAS.** We turn to Mr. Sommer.

STATEMENT OF HENRY J. SOMMER, ESQ., MILLER, FRANK & MILLER, PHILADELPHIA, PA, ON BEHALF OF THE CONSUMER BANKRUPTCY ASSISTANCE PROJECT

Mr. **SOMMER.** Thank you, Mr. Chairman. Thank you for allowing me to appear today.

I have been representing consumers, mostly low-income families in Philadelphia, for almost 25 years. I first testified before this subcommittee about 16 years ago—I am getting to feel old—and there was a very similar situation.

Bankruptcies had gone up. Creditors were blaming the 1978 Bankruptcy Reform Act. They said there was no more stigma involved in filing bankruptcy. They blamed lawyer advertising. They had paid for a study by the Credit

Research Center, which purported to show that debtors could afford to pay their debts.

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In 1984, Congress gave them much of what they had sought and the creditors publicly declared that the problem had been solved. And what happened after that? As you can see from that graph that someone has put up there, bankruptcies went up faster than they had before.

I think that experience ought to teach us several things. The first is that no matter what changes you make, the banks will always want more. In the 1980's and 1990's, they got the 1984 amendments to the code, they got rate deregulation, they got the weakening of other consumer protections and they still want more.

They want more because their main goal is maximizing their profits. I can understand that. But that should not necessarily be the Congress' main goal.

More importantly, we should have learned that bankruptcy laws don't cause the debt problems that need bankruptcy relief. Changing those laws will not make those debt problems go away. Bankruptcy laws don't cause layoffs, they don't cause uninsured medical bills, they don't cause disability, they don't cause marital separations. Changing the bankruptcy laws will not change whether people get into debt.

How many people do you know who think about bankruptcy laws when they go to buy something? American families, your constituents, have not suddenly changed into irresponsible deadbeats. Do you really think that the many thousands of people in your own districts who filed bankruptcy cases, people who might be your neighbors and your friends, are all, or even mostly, credit abusers?

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There has been a large increase in the amount of family debt in this country. That may be a problem, but bankruptcy is a symptom of that problem, not the cause.

In the time I have left, I'd like to talk about two effects that H.R. 3150 would have, effects which I don't think, based on what's been said today, its sponsors intend.

The first of these unintended consequences is that far more families would lose their homes to mortgage foreclosure than do now. As you probably know, chapter 13 in its current form has helped millions of families save their homes from foreclosure by giving them a way to catch up on their mortgage payments.

Most of the people I have represented have filed chapter 13 cases to save their homes. The vast majority of the people I represented, who were primarily low-income, could not have saved their homes under H.R. 3150 for several reasons.

First of all, the bill requires a minimum of $50 per month to be paid to unsecured creditors in every chapter 13 case. The people I represented, people who had incomes of $1000, $1100 a month, at or near poverty levels, which had often been sharply reduced from what they were before, really struggled to make their mortgage payments, to make the payments toward the mortgage arrearages and the trustees' fees. They simply did not have the additional $50 to pay to their unsecured creditors.

Second, H.R. 3150's payment formula would force debtors to pay their credit card debts and other unsecured debt before they caught up on their mortgages. It would, therefore, take them longer to catch up on their mortgages if they could even do it during the time allowed, and it would cost them more because interest would be accruing on their mortgage arrears under current law.

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Given that we're talking about people with unstable incomes which are stretched to the limit, the longer it takes to cure a mortgage default, the more likely it is that something will happen to disrupt those families' incomes.

It doesn't take much—a major plumbing bill, a major car repair, an unexpected medical bill. It is absolutely predictable that if you make it take longer to catch up on a mortgage default, many of the people who now have successful plans to save their homes will have plans that fail.

H.R. 3150 doesn't treat those failures very kindly. Under current law, the people could pick up where they left off if they got their incomes reestablished. That's pretty common. It probably happened in about 20 percent of my cases, and in most of those cases, people ultimately saved their homes. The creditors didn't object to that; they knew they were in good faith.

Under H.R. 3150, it would be a major burden and expense for people to try again, even if they'd made years of payments under a prior plan, and even if no creditor opposed it. Even worse, if a person had happened to file a bankruptcy 3 or 4 years earlier and get a discharge, that person would not even be allowed to try to catch up on a mortgage in chapter 13.

The second unintended consequence is that while the sponsors, I think, sincerely believe that H.R. 3150 is targeted at upper middle-class debtors who can afford to pay their debts, the real brunt of the bill would be borne by low-income families.

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I know that the creditor lobbyists, when they come to you, say "we're not interested in the low-income people, we're not after them and this bill won't affect them." Well, out in the real world where I practice every day, they don't make that concession.

I see people every day who have been aggressively pursued by collection agents, who've been threatened with repossession and foreclosure, who sometimes have had their household goods scheduled for sheriff sale, one of the things we still have in Pennsylvania. And they are often driven to tears and even psychiatric care by these kinds of efforts.

In the bankruptcy courts around the country, we're seeing the same thing. We see threats of dischargability complaints and actual dischargability complaints, mainly not against the upper middle-class debtors, but against the pro se debtors and the debtors who can't afford a lawyer to fight back.

And there are some pretty obvious real world reasons for this. Collection lawyers and collection agents make their money on volume. They are usually paid a flat fee or a percentage of what they collect. It's a much more effective use of their resources to extract quick settlements from 20 poor people than to engage in lengthy litigation with one or two middle-class people.

And those settlements are what the creditor really wants. They don't want to push someone into chapter 13, where they have to share the debtor's income with all the other creditors. They'd much rather get a reaffirmation.

In my written testimony, and I'm not going to do it here, I go through some of the provisions that would give them even more levers to do this. I don't think there are effective sanctions in the bill to prevent that behavior.

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I don't think that's what the sponsors of H.R. 3150 intend. I don't think they want people to lose their homes. But if this bill were passed in its current form, that's exactly what would happen.

Thank you.

[The prepared statement of Mr. Sommer follows:]

PREPARED STATEMENT OF HENRY J. SOMMER, ESQ., MILLER, FRANK & MILLER, PHILADELPHIA, PA, ON BEHALF OF THE CONSUMER BANKRUPTCY ASSISTANCE PROJECT

My name is Henry J. Sommer and I am an attorney specializing in bankruptcy and consumer law matters. For over 23 years, I have represented families and individuals in Philadelphia who have sought my help for serious debt problems, most often involving mortgage foreclosure. I am a Supervising Attorney at the Consumer Bankruptcy Assistance Project, a pro bono program serving low income people and I am of counsel to the law firm of Miller, Frank & Miller. I am also a member of the National Bankruptcy Conference and the Federal Judicial Conference Advisory Committee on Bankruptcy Rules. However, I do not speak today on behalf of any of those organizations. I am here, and I am grateful to the Committee for inviting me here, to relate my own experiences in representing families with financial problems that are relevant to the Bankruptcy Code amendments now being proposed.

I first testified before this Committee about sixteen years ago. At the time, Congress was considering amendments proposed by the consumer credit industry based upon the creditors' arguments that times had changed, that the 1978 Code had caused increased bankruptcy filings, and that there was no longer any stigma attached to filing for bankruptcy. In 1984, Congress passed a package of anticonsumer amendments to the Code and the creditors publicly announced that the problems had been solved. In the next few years, bankruptcy filings, which had actually started to decrease before then, began going up faster than ever.

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I'd like to think we learned two things from that experience. First, it showed that the bankruptcy laws do not cause people to have debt problems that require bankruptcy relief and changing those laws will not lessen the need for relief. The reason that bankruptcy filings have increased is that with deregulation of interest rates and the drop in their cost of funds, banks have found it very profitable to aggressively market more and more credit to a much larger number of people.

The people I see in my practice need bankruptcy relief because of some life event that left them unable to pay their debts. My clients have lost their jobs, suffered health problems or disability, or had a marital breakup that left them unable to pay all of the bills they were regularly paying until then. People do not think about the bankruptcy laws when they go out and buy things, so changing those laws will have no effect on the amount of credit they incur. They only think about bankruptcy once they realize they have no way to keep paying, usually when they're facing foreclosure, repossession, utility shutoffs, collection harassment, or wage garnishment.

Second, the experience since the 1980's has shown that no matter what changes the creditors get enacted, they will always want more, as long as there are any consumer protection laws and they think they can further increase their profits. Their multi-million dollar public relations and lobbying campaign claims once again that there is no stigma to filing bankruptcy, that Chapter 7 debtors can pay their debts, and that debtors are now filing "bankruptcies of convenience." These claims are no more true now than they were in the early 1980's. American families, your constituents, have not suddenly become irresponsible deadbeats. While I'm sure you may have heard of one or two bankruptcy abuses, perhaps anecdotally, the fact is that virtually all of my clients are extremely upset at the thought of filing a bankruptcy case. They are not people who can pay their debts and they are not people who incurred debts beyond their ability to pay at the time they were incurred. Do you really think that the thousands of the people in your own districts who have had to take that step, people who are your neighbors and perhaps even friends, are all or even mostly credit abusers?

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Turning to H.R. 3150, and recognizing that I have limited time, I want most to talk about some of the consequences

I think are likely to result from that bill which you might not have considered, and which I do not believe its sponsors intended.

H.R. 3150 WOULD MAKE IT HARDER TO SAVE HOMES FROM FORECLOSURE

The first unintended consequence is that H.R. 3150 would make it much harder for families to save their homes from mortgage foreclosure. As you probably know, one of the primary functions, and great successes, of Chapter 13 has been its use to allow millions of homeowners to cure arrearages on their mortgages over a reasonable period of time. Most of the people I have represented in bankruptcy cases have been low income families trying to save their homes. Under H.R. 3150, hardly any of those families would even be eligible to file a Chapter 13 case. My clients, most of whom were below the poverty line, barely had the money to pay their current mortgage payments, a payment toward their arrears and the trustee's fees. Under H.R. 3150, they would have to add to that $50 per month for their unsecured creditors, which they simply do not have, or lose the chance to save their homes.

Indeed, it is not even clear under H.R. 3150 that debtors could devote any money toward their mortgage arrearages during the first few years of the plan. The bill appears to require the payment of unsecured debts before mortgage arrearages, or at least concurrently, under a formula that may not take into account a family's true living expenses. This is a fundamental change in the policy of the Bankruptcy Code, which right now places a higher value on home ownership and the payment of mortgage debts than it does on payment of unsecured debts like credit cards and hospital bills. It is an indisputable fact that the longer it takes for the debtor to cure an arrearage, the greater the likelihood that the plan will fail due to an income interruption before the mortgage arrearage is cured. Under the Supreme Court's *Rake* v. *Wade* decision, it will also take more money to cure those arrears, because interest will accrue on the arrears. Therefore, it is absolutely predictable that many families I represent, who would be able to save their homes from foreclosure under current Chapter 13, would lose their homes under H.R. 3150. For the same reasons, it will be much harder for families to catch up on back child support and taxes, debts which ought to be considered more important than credit card obligations in which banks voluntarily undertook the risk of nonpayment.

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H.R. 3150 compounds this problem by placing severe restrictions on legitimate repeat bankruptcy cases. If a debtor has filed a Chapter 7 case and four years later falls behind on a mortgage due to medical problems or some other totally unforeseeable reason, that debtor could not use Chapter 13 to catch up on mortgage payments and save the family's home. If a debtor pays for three years into a Chapter 13 and is temporarily laid off for six months, causing the case to be dismissed, that debtor must incur a major burden and expense to begin a new case, *even if no creditor objects*. Remember, the families who are in bankruptcy are often families with unstable incomes, usually stretched to the limit. It is not uncommon for a Chapter 13 case to be dismissed and for the debtor to refile and successfully complete the second case. The large majority of the repeat filings I have handled ultimately resulted in the family saving its home. In my experience, creditors rarely even object in such cases because they know the debtor is filing in good faith.

H.R. 3150 WOULD HURT LOW INCOME FAMILIES THE MOST

H.R. 3150 has been described as a bill that is not aimed at low income debtors and that would not affect them. No doubt its sponsors believe that is true. As someone who primarily represents poor families, I must tell you this simply is not the case. In addition to making it impossible for low income families to save their homes in Chapter 13, this bill would hurt them in a variety of other ways and indeed would hurt them far more than affluent debtors.

First, the bill permits creditors to file motions to bar debtors from Chapter 7 regardless of how low their income is. Although the bill's eligibility formula would not apply to debtors with incomes below 75% of the national median income (which, in fact, is equivalent to the poverty level in some high cost-of-living areas, especially for larger families) it does not prevent creditors from moving to dismiss cases of families with lower incomes. My experiences over many years of representing low-income debtors, and the experiences of courts around the country, give every reason to believe that such motions, and threats of such motions, will be very common in cases of low income and pro se debtors.

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Although creditor lobbyists and trade associations may concede in Washington, D.C. that low income families cannot afford to pay their debts, their local representatives and collection lawyers and collection agents make no such concession. In my practice, I see them systematically and aggressively seeking payments from my clients, through frequent and abusive collection calls and letters that drive them to tears and sometimes psychiatric care, lawsuits, and even the scheduling of sheriff's sales of their household goods. In the real world of day-to-day collections, even the poorest debtors are pushed to pay $10 or $20 or $30 a month they cannot afford to pay.

We have seen the same kind of collection behavior in the bankruptcy courts around the country. Creditors and their collection lawyers regularly extract reaffirmation agreements, from unrepresented bankruptcy debtors who cannot even afford to hire an attorney, by threatening to bring dischargeability litigation or to repossess household goods of minimal value, or by actually bringing dischargeability complaints without having even investigated the underlying facts. Although many bankruptcy courts have documented these abuses and have begun to try to prevent them, they go unchecked in most places because the Code does not have effective tools (like those in H.R. 3146) to prevent them.

Why, you might ask, would creditors and collection lawyers devote so much of their effort to low income debtors? They do so because a cost/benefit analysis of their efforts tells them it makes sense. Collection lawyers and collection agents make their money on volume. The have routinized practices with form letters and form complaints designed to induce quick settlements. They are usually paid a flat fee or a percentage of what they collect. It is a much more effective use of their resources to settle with twenty poor people, who are pro se or cannot afford to pay to defend a complaint, than to litigate with one upper middle class debtor who can actually pay a lawyer to fight for him. The last thing these lawyers want is contested litigation that will take a lot of their time and money. In fact, when cases are contested by competent counsel, creditors frequently drop them almost immediately.

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Experience around the country has also shown that the type of attorney's fee provision in section 103 of H.R. 3150, requiring a showing the creditor's action was not "substantially justified," has not proved strong enough to prevent these abuses in dischargeability litigation claiming fraud. The family that has little income, when faced with the choice of paying many hundreds of dollars to litigate or paying $50 per month in a reaffirmation, has little choice but to capitulate. There is no way that the "substantial justification" standard would be sufficient under the far vaguer "totality of the circumstances" and "inappropriate use" standards proposed for section 707(b). And it would not even begin to prevent threats of 707(b) motions to coerce reaffirmations, which never even result in a motion being filed.

Similarly, there is no sanction at all for creditors filing unfounded objections to debtors' statements of "extraordinary circumstances" under section 101 of the bill. Collection lawyers could file such objections by the hundreds and not even bother showing up at the hearings, where the debtor would still have the expenses of missing a day of work and paying perhaps several hundred dollars to meet the burden of showing a budget item is justified, not to mention the burdens on the courts who would be required to have a hearing on every objection.

The only way to prevent these abuses is to make section 707(b) totally inapplicable to debtors with modest incomes. A more reasonable income floor, which takes into account the higher costs of living in some parts of the country and the needs of larger families is essential. Prohibiting creditors from filing §707(b) motions, while allowing them to bring forth evidence of any abuse at the §341(a) meeting, would also be a fair compromise, because it would require at least some evidentiary showing by a creditor, who would not be allowed to simply file hundreds of standard form motions or threaten such motions.

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There are numerous other provisions in H.R. 3150 which would hurt low income families who are unable to defend themselves or afford lawyers to represent them. The bill not only fails to sanction the creditor overreaching which has preyed on such debtors, as documented by bankruptcy courts around the country, but it actually expands the opportunities for those abuses.

For example, the bill substantially narrows the definition of "household goods," By doing so it allows creditors to take nonpurchase-money security interests in many household items and threaten to repossess them if debtors do not either pay the retail value of the goods in cash (which low income debtors would never have) or reaffirm debts far in excess of the value of the property. In the past, creditors have used this definition to argue that they should have the right to threaten repossession based on *nonpurchase-money* security interests in children's swing sets, lawn mowers, children's toys, sleeping bags, family heirlooms and similar items—items of no significant resale value but tremendous emotional value to a family that cannot afford to replace them. Courts have uniformly rejected these arguments, but this bill would accept them, expanding the scope of reaffirmation abuses from purchase-money security interests to nonpurchase-money security interests. Congress should instead prevent such reaffirmation abuses, by adopting the provisions addressing them in H.R. 3146.

Similarly, by adding dischargeability exceptions to Chapter 13, the bill increases the opportunities for creditors to file the types of abusive fraud complaints which have been found by many courts to be baseless and unjustified attempts to coerce reaffirmations from debtors who cannot afford to defend them. The new presumptions of nondischargeability will fall mainly on low income debtors who are unsophisticated, do not have the time, budget flexibility, or attorney advice to plan their bankruptcy cases carefully, have to file on short notice to prevent utility shutoffs or other impending creditor action, and will not have the funds to defend dischargeability complaints. Again, rather than creating more opportunity for creditor abuse, Congress should adopt measures, such as those in H.R. 3146, to restrict those abuses.

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The presumption against permitting a second bankruptcy filing when papers in a prior case have been filed incorrectly would hurt almost exclusively those low income pro se debtors whose cases are dismissed because they could not afford an attorney to meet the bill's complex new filing requirements and cannot afford an attorney to litigate their right to refile. Indeed, the complex notice procedures, requirements for obtaining past tax returns, annual budget reviews, audits in numerous cases, and new opportunities for creditor objections and litigation would greatly increase the number of pro se debtors, and low income debtors denied bankruptcy relief altogether, because they would increase the attorney's fees charged in every bankruptcy case by hundreds of dollars. Even those few legal services programs that still handle bankruptcy cases, and pro bono programs like my own, would be able to help far fewer people because there will be so much more work involved in every case.

AMENDMENTS TO THE BANKRUPTCY CODE MUST BE NARROWLY CRAFTED TO PREVENT UNINTENDED CONSEQUENCES

From what I have read of their statements, I do not believe that it is the goal of H.R. 3150's sponsors to target lower income families. I also do not believe it is their goal to increase the reaffirmation and dischargeability complaint abuses that have recently gotten so much press attention and brought actions by state attorneys general around the nation.

Nonetheless, I have no doubt that the bill will miss its intended target, those few debtors who game the system and have the ability to make substantial repayment of debt, because those debtors can afford counsel to plan their cases and litigate against creditors. The debtors who would be hurt are those who have low incomes and cannot defend themselves, precisely those who are most in need of bankruptcy relief.

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Some of the stated goals of H.R. 3150, such as reducing the "irresponsible" use of credit, will never be accomplished by changes in the bankruptcy laws. People who incur credit are not thinking about the provisions of the Bankruptcy Code, and the amount of credit extended is mainly a function of the amount of creditor marketing and credit standards.

While some consumers may unwisely take on too much debt, we should not deny them relief when they need it any more than we should close the cancer wards to those who have unwisely taken up smoking. Both products have been heavily marketed, with little or no warning of their dangers.

What can be done is to craft narrowly drawn provisions designed to prevent true abuses of the system by both debtors and creditors, without hurting millions of people, including other creditors, who are innocent of any abuse. I would be happy to work with the Committee in an attempt to accomplish this kind of true bankruptcy reform.

Mr. **CONYERS.** Mr. Chairman, you're aware we have a vote on.

Mr. **GEKAS.** Do we?

Mr. **CONYERS.** Oh, I'm sorry. I'm sorry.

Mr. **GEKAS.** You're hearing bells where there aren't any.

Mr. **CONYERS.** Excuse me.

Mr. **GEKAS.** All right. Mr. Mason.

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STATEMENT OF MATTHEW J. MASON, ESQ., ON BEHALF OF THE UNITED AUTO WORKERS–GENERAL MOTORS LEGAL SERVICES PLAN AND THE INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

Mr. **MASON.** Thank you, Mr. Chairman.

My name is Matthew Mason. I'm appearing on behalf of the International Union of the United Auto Workers, and on behalf of the UAW–GM Legal Services Plan. I must say, however, that I am not making any appearance on behalf of the General Motors Corporation and none of my statements, of course, are intended to reflect any of their positions or policies.

I've been involved in bankruptcy for the past 20 years in the Legal Services Plans. The Legal Service Plans is one of the largest law firms in the United States. We employ 450 lawyers, we have eight-one offices and we cover over 20 states.

Pretty much, wherever there is an auto plant, we have an office or several offices. We handle enormous volumes of cases every year. For the last 7 years, we've handled 250,000 new cases each year. And surprisingly, within that framework of this large volume of cases, bankruptcy is a very, very small percentage of the cases that we see.

However, when we see people who come to us with bankruptcy problems, they are very severe problems and ones that need to be addressed.

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We've heard a fair amount of testimony today about how people come to use the bankruptcy system as the first option, as a way of managing their financial affairs. That view is directly contradicted by my experience of 20 years working with bankruptcy clients and reviewing files in these 80-some offices throughout the United States.

We actually see debtors coming to us as a last resort. As my colleague has stated, these debtors try to make partial payments. They borrow money from their friends. They borrow money from their family. They try to make arrangements with the creditors. They even go so far as to borrow other money to pay prior debts.

One of the main problems with the credit card industry today is that people are solicited to use credit cards not to purchase items, but to actually consolidate their bills and pay off other credit cards. We see large numbers of instances where people take cash advances not to buy things, but merely to make the minimum payments so that they can maintain a good credit standing.

The one thing that is clear to me about UAW workers, retirees and spouses is that they value highly their credit rating. They will do almost anything to preserve their credit rating, and by the time they come to us, they have exhausted all those possible opportunities.

When they do come to us, the UAW–GM Legal Services Plan does not view bankruptcy as the first option; we view it as the last option. We have many means available to us to try and work out matters with creditors. But our experience is that creditors are increasingly unwilling to work with debtors.

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First, when we have someone come to us, we do an extensive financial questionnaire. A lawyer personally interviews each client. If there is an emergency, we try to take care of the emergency, such as a home foreclosure, an appropriate use, we think, of the bankruptcy process.

But if it's not an emergency, we try to solve the problem by other means such as payment plans. If there are lawsuits, we defend and try to make payment plans. If there is a mortgage arrears, but not a foreclosure, we try to do a workout.

But our experience has shown that creditors are becoming more and more aggressive. And I have one simple example in my testimony that can illustrate this. A client, William C., came to us with a fairly large home loan, over $100,000. He had been in default because he had to use a substantial part of his money to pay for the criminal defense for one of this children.

He had a VA loan. He was in default and came to us while in foreclosure. We managed to file for him to save his home, but then we inquired about his VA loan and the responsibilities under the VA Act. Under the VA regulations, we know the VA should get notice of his default and that he is required to get notice of opportunities to work out the debt. For example, a creditor is required to extend workout options such as repayment plans, refinance the debt, or modify the interest rate. We wondered what had happened with him; why had he come to us first instead of being offered a suitable workout by the lender.

We asked the creditor if they had copies of any notices they sent to the VA. There were none. We asked our client if he had received any of these notices. He said no. And when we asked the VA what was in their file, it was blank. They only had the mortgage application and the mortgage documents.

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We see this behavior practiced throughout the credit industry. We see increasing garnishments, quick lawsuits and an unwillingness to work with debtors really under any circumstances.

Another client came to us with a credit card problem. A 23-year-old student had been offered $5,000 in preapproved checks. He already had over $15,000 of debt and he only earned $15,000 a year. He was laid off and, of course, he fell behind on his credit cards.

He called to make a payment arrangement. The lender demanded $200 a month. He could barely afford $100, which he offered. They refused. Before he knew it, he was faced with a lawsuit and possible garnishment of his wages, and he turned to us for protection.

In reviewing the bills that are before the House, these are a couple of things that the committee should consider. There has been a fair amount of discussion about abuse. In the 1980's, I knew what abuse was. It was the Hollywood starlet who filed bankruptcy and then turned around and made a motion picture for a million dollars. It was the professional athlete who filed bankruptcy when he had another million-dollar contract waiting to be signed.

In the 1990's, I knew what abuse was. It was Bowie Kuhn when he moved from New York to Florida and invested his entire personal fortune in that state's unlimited real estate exemptions. But today, I'm told that abuse is somebody who makes $37,000 a year and who can afford to pay $50 a month for 36 months to his creditors.

When we are discussing people of low and middle income, that there has to be a more realistic approach to what is an abuse of the system. People do get in debt; people do get in debt over their heads. They are driven to the limits financially; they are driven to the limits emotionally. There must be some opportunity for them to be relieved from those responsibilities so they can become productive members of our society again.

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What we try, with the Legal Services Plan, is to resolve their problems. If we can't do it, then we have to turn to the bankruptcy process. Bankruptcy is a last resort. However, it serves an important purpose. It relieves low and middle income consumers of the strain of overwhelming debt. It allows them to become productive employees, better workers and participants in our United States democracy.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Mason follows:]

PREPARED STATEMENT OF MATTHEW J. MASON, ESQ., ON BEHALF OF THE UNITED AUTO WORKERS-GENERAL MOTORS LEGAL SERVICES PLAN AND THE INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

My name is Matthew J. Mason, Assistant Director of the UAW–GM Legal Services Plan. I am making this joint statement on behalf of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, UAW and the UAW–GM Legal Services Plan. This statement does not and is not intended in any way to reflect the views of the General Motors Corporation or any of its subsidiaries.

I speak today based upon my experience of having worked for the largest prepaid legal services plan in the United States for these past twenty (20) years. The combined UAW Legal Service Plans employ 450 attorneys in eighty-one (81) law offices located in twenty (20) states. These attorneys provide legal representation to nearly one million active and retired UAW members and approximately another two million spouses, surviving spouses and dependents. The legal service Plans provide prepaid legal services for most civil matters including debt, foreclosure and eviction defense as well as bankruptcy. The Plan is unique in that the legal services including bankruptcy are provided at no cost to the member. The cost of the legal services, including bankruptcy filing fees, are paid out of a collectively bargained fund much like an insurance fund.

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Currently there are four bankruptcy "reform bills" pending in the House of Representatives and the Senate. The UAW has endorsed H.R. 3146, sponsored by Representatives Nadler and Conyers, as the bill that represents the most reasonable approach to bankruptcy reform.

The UAW strongly opposes H.R. 2500, H.R. 3150 and S. 1301, each of which would radically restructure bankruptcy law in a way that would be detrimental to working families.

In the hope of reducing the raw number of bankruptcy filings, these bills create a system designed to fail debtors without regard to the individual situations of working families.

The bills accomplish the task by placing unnecessary roadblocks in front of responsible debtors who are trying to reorganize their lives, financially and emotionally. First, the bills unnecessarily restrict access to the bankruptcy system. Second, those debtors who qualify for filing must provide extensive documentation upon pain of dismissal. These procedural traps are designed to cast the unwary and unsophisticated debtor from the protection of the bankruptcy laws. Third, once dismissed from the system, the debtors are barred from future bankruptcy relief, regardless of changed circumstances or the ability to restructure their debts. Once barred from the protection of the Code the inevitable result is the loss of homes, apartments and transportation to work. The already intolerable strain on the family created by too little money, too many debts and no future deprives the working family of the opportunity to again participate as productive individuals in the American system.

I. THE BANKRUPTCY EXPERIENCE OF THE UAW LEGAL SERVICES PLAN SHOWS THAT THE INCREASE IN FILINGS IS NOT DUE TO LAWYER ADVERTISING, THE EASE OF FILING BANKRUPTCY OR THE LACK OF A BANKRUPTCY STIGMA.

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The UAW Legal Service Plans handle over 250,000 new cases each and every year. The Plans have opened that number of new cases for the last seven years. Historically bankruptcy has been a relatively small part of our practice accounting for about two (2) percent of all new cases. However, even at that level the Plans filed 1,300 new bankruptcies each in 1995 and 1996.

However, in 1997 our bankruptcy intake doubled from two (2) to four (4) percent of total cases. In 1997 about ten thousand (10,000) new clients called to inquire about bankruptcy. As our intake doubled, our filings doubled as well. In 1997 we filed close to 2,500 bankruptcies.

A. The Plans have experienced a dramatic increase in all types of debt problems despite the fact that we have never advertised our services and the number of total cases have remained constant.

These increases cannot be explained by some of the common reasons suggested for the increase in consumer bankruptcy. The Plan does not and never has advertised its services. In most locations we are not even listed in the Yellow Pages. If an entry exists, it is the minimum one line entry giving the name of the office and the telephone number.

Similarly, the Plan's payment of all bankruptcy costs including filing fees has not changed in twenty years. This policy has been in effect since the inception of the first Plan in 1978.

In addition the increase in bankruptcy occurred despite the fact that the total of new cases of all kinds have remained constant. What has changed is the mix of cases. In the last year bankruptcy, debt defense and foreclosure have doubled as a percentage of all the cases we handle.

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B. The Plan has not changed its policy of using bankruptcy as a last resort after trying other approaches to resolving debt problems.

Our approach to bankruptcy has also not changed. Given the serious consequences of filing bankruptcy, we have never approached bankruptcy as a first option. In our view bankruptcy is a last resort when all other means have failed. When our clients contact us, we ask them to complete a financial questionnaire. We interview the client thoroughly about their debts and their assets. We prescreen for emergency situations such as home foreclosures. If there is no emergency, we may pursue several options. For the client with significant unsecured debt, we may suggest credit counseling. If the client is behind primarily on a mortgage, we will attempt a workout with the lender. If the client has been sued, we will defend the lawsuits, stop garnishments and attempt to work out payment plans that are realistic. As a result we only file bankruptcy in one out of every four clients who contact us about bankruptcy, a figure that has remained consistent over the last seven years.

II. THE AGGRESSIVE COLLECTION TACTICS OF CREDITORS AND THE INCREASED MARKETING OF CREDIT CARDS ARE DRIVING THE CURRENT HIGH FILING RATES.

A. Creditors have become far more aggressive in collecting debts.

While our total cases have remained the same, the number of debt collection lawsuits, foreclosures, garnishments and evictions have increased. Creditors are increasingly unwilling to work with their own debtors, to the point where the creditors even ignore the federal laws and regulations designed to assist debtors in need.

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For example Larry C. contacted us in 1997 after he received a foreclosure notice on his home. Mr. C had a good job in the auto industry but he had a significant mortgage payment. If everything went well, he was able to make his payments in a timely fashion. However, disaster struck that same year. Mr. C's son was arrested on a serious criminal charge. To pay for the legal bills (the Plan does not handle criminal matters) Mr. C used money that otherwise would have gone toward his normal bills.

He quickly fell behind on his VA mortgage. Once he fell behind one payment, he was required to make two payments plus late fees to catch up. With a mortgage payment of $1,100 a month, the arrears quickly rose. When we got the case, the foreclosure sale had already been scheduled. The company had moved from default to sale in a matter of months. We filed an emergency Chapter 13 to stop the sale. Under VA regulations the lender must offer all reasonable opportunities to extend payments, extend the loan and accept partial payments plus notify the VA prior to foreclosure. Mr. C advised us that he had never received any notices about the possibility of reworking his loan. We contacted the mortgage company and asked for copies of any notices to the client about a possible workout. They never responded. We called the VA. Their file on Mr. C was blank except for the original mortgage documents.

B. Unsophisticated consumers, convinced by aggressive marketing and the unsolicited offer of large sums of free credit, extend their borrowing to the point where any unexpected event creates a financial crisis.

1. The marketing of credit has also changed.

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Consumers are relentlessly bombarded by television and by mail that the good life is obtainable by obtaining another credit card or a home equity loan.

Consumers, ranging from college students on minimum wage jobs to senior citizens on a fixed income, receive unsolicited blank checks worth thousands of dollars. The companies not only suggest how to use the money but also tell you that the faster you write the checks, the greater your savings will be.

A prime example of the success of this marketing occurred with one of our young clients. Don D. a twenty-three (23) year old college student lived at home with his parents. Don attended school and was employed for a time at Blockbuster Video at $7.00 an hour. His highest annual earnings were $15,000. In the summer of 1994 he received a letter of solicitation from VISA pre-approving him for a Five Thousand Dollar ($5,000) line of credit. The letter enclosed "convenience checks" that he could use immediately by calling a twenty-four (24) hour toll free number. The unsolicited letter used a "teaser rate" as a hook. By taking advantage of this offer, he would pay no interest on any balances carried in the first sixty (60) days.

The quicker you use these checks (and your new card) either to make purchases, pay bills or transfer balances from other cards, the greater your savings will be.

Here are just some of the ways that you can use your Convenience Checks:

+ Pay off higher interest credit cards
+ Give a gift to your family or friends
+ Pay college tuition

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+ Obtain cash for a vacation
+ Remodel or redecorate your home
+ Get cash to cover auto-related or other emergency expenses
+ Pay bills

Don used the card as suggested. However when he lost his job at Blockbuster Video, he could no longer afford the payments. The company demanded a $208 a month payment. He could only afford $108 a month. Don already had $11,500 in student loans as well as a car loan he had taken out for his parents. The company refused his offer and continued collection action. Faced with no real income, no immediate prospects to repay the debt compounding at 20% interest per year and an unwillingness of his creditors to work with him, bankruptcy was the only available solution to solve his financial problems.

2. Even the consumer with the best of intentions can be trapped by the credit card industry, especially if they are living close to the margin.

Given that most credit cards payments are due within 20 days of the date of the statement, the chances are excellent that most consumers incur significant penalties for late payments, further compounding their financial problems. Once the late payments start, the downward cycle begins. The interest charges increase. Once the interest charges accumulate, the minimum payment increases.

Many UAW members and retirees base their borrowing on their ability to make the minimum payments. While purchasing goods or borrowing money, the question most often asked is "how much is the payment?"

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Once the minimum payments increase beyond their available cash, workers look for other sources of money. They start to use cash advances to make the minimum payments. In an effort to keep their credit, they make so many small payments that they lose sight of the large payments for their homes and their cars.

3. Debtors can be further trapped by home equity loans.

Anyone who has equity in a home and some income is a prime target for the sub prime, home equity lender. Asa A. worked for the Chrysler Corporation for 34 years. After he retired, he became disabled and his son became his conservator. Asa's son was not good at managing money. He fell behind on the home payments forcing his father to file a Chapter 13 in 1995. Eventually the Chapter 13 was dismissed. The son then used a power of attorney to refinance the home. He borrowed $33,000, $3,700 of which went to fees and costs. The mortgage company charged a $2,500 broker fee, a $350 processing fee, a $500 underwriters fee and four other separate fees totaling another $365. The interest rate charged was 12.87% and the payment was $530 a month. The son then took out a second secured loan for home windows and purchased a van, using all of the equity in the home.

In time the van was repossessed and the home was in foreclosure. We filed the second Chapter 13 one day before the sheriff's sale. If we had filed one day later, this disabled retiree would have lost his home that he had worked for 34 years to own.

III. UAW WORKERS, RETIREES AND SURVIVING SPOUSES TURN TO BANKRUPTCY PROTECTION AS A LAST RESORT AFTER A CRISIS HAS MADE THEIR FINANCIAL SITUATION HOPELESS.

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UAW members are driven to create a better life for their families. They take the opportunity to work whatever overtime is available. UAW members are known for holding second and third jobs to tide them through periods of layoff and reduced hours. They tend to have working spouses, a necessity today to maintain a middle class standard of living.

Even so a certain percentage of them live close to the edge financially. For active workers the high cost of mortgage payments and taxes is the major problem. For retirees and surviving spouses the problem is living on a fixed income. The most vulnerable are the retired and the disabled who do not have the ability to earn additional money when times are bad.

In preparation for testimony before the National Bankruptcy Review Commission in 1997 I surveyed 13 of our largest offices located in seven states, Michigan, Indiana, Ohio, Illinois, Oklahoma, New York and Delaware to get a better profile on our typical client. After the review, several things were clear. Invariably the clients were low to middle income working people who had worked hard their entire life. Most often the reason for filing bankruptcy resulted from one or more catastrophic events that were beyond their control. In fact it was surprising to me how little control many of the workers had over their lives and their financial affairs.

Many workers attempt to work things out with their creditors or turn to credit counseling prior to seeing us. A number of workers are victimized by responding to ads that promise to solve their financial problems, only to see their money stolen by credit scam artists.

Over time the workers and spouses become exhausted from the constant pressure of bill collectors and the threats to garnish or levy their wages and take their homes and cars. The strain leads to problems on the job, disability and the disintegration of the marriage. Often that process can go on for years and may well include initial attempts at Chapter 13 plans.

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A. Common problems typically result in the need for bankruptcy protection. More often than not, it is not a single problem that creates the financial crisis.

Typically the events that precipitate the downward spiral fall into the following categories:

1. Interrupted income due to layoff or disability.
2. Loss of income through loss of a job.
3. Increased expenses by having to maintain two households due to divorce or separation.
4. Sudden cutbacks in overtime upon which the workers had become financially dependent.
5. Unexpected and large medical bills not covered by insurance.
6. Loss of income from being an active worker to becoming a retiree.
7. Increased expenses due to supporting grandchildren whose parents are nonfunctional.
8. Suspected substance abuse by a spouse or child that affects the innocent spouse or parent.

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B. The common problems can be easily seen in actual cases.

1. Ron E's marriage dissolved. He also became totally and permanently disabled. A second Chapter 13 allowed Ron to save his home.

Ron E. worked for 12 years at a General Motors plant in Wilmington, Delaware. He began to have serious financial problems in 1994. His marriage ended. It became impossible to manage the family bills on his income alone. When he was finally threatened with utility shutoffs and a mortgage foreclosure, he turned to the UAW Legal Services Plan for a Chapter 13. In April, 1994 he filed a Chapter 13. Within months he injured his knee and was unable to work. During that time he had no income and could not make his mortgage or plan payments. He was forced to dismiss the case.

Within 5 months Ron returned to work. He filed a second Chapter 13. This Plan was confirmed and saved Ron's house. Ron has been faithfully making his payments since that date.

Recently Ron suffered another setback. He has a progressive muscular disease and was determined totally and permanently disabled by the Social Security Administration. His income was cut by more than 50%, from $3,500 per month to $1,477 per month. Yet he had the same bills and expenses.

Once again his home was in jeopardy. He was forced to propose an amended plan that paid the mortgage arrears over a longer period of time but left no money for unsecured creditors. The trustee objected to the Plan because there was no minimum payment of 10% to unsecured creditors. Fortunately the judge exercised his discretion, dismissed the objection and allowed Ron to save his home.

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2. A second Chapter 13 saved Bob and Linda's home and their oldest son's future despite a 20% cut in pay, a failed business and an 18% home equity loan.

Bob and Linda were a typical working class family. They had two sons, ages 15 and 18. The oldest child had just started college. Bob worked in the auto plant. Linda tutored children for a living. Their trouble started when Linda tried to make her tutoring into a business. Lacking capital she financed the business with cash advances from her credit cards. When that was not sufficient, she turned to a home equity loan. They borrowed their $40,000 in equity and agreed to repay the loan at 18%. Then disaster struck. Bob's overtime was cut and the business was not profitable.

Creditors sued them. Judgments were taken and eventually their mortgage was foreclosed. Initially they sought assistance from a private attorney with the goal of saving the business. They paid an attorney over $3,000 in attorney fees and filed a Chapter 13. Given their income and expenses they were unable to comply with the Plan. The case was dismissed. When the case got to us, the situation was desperate. By then they had lost both of their cars and were again on the verge of losing their home. The financial strain began to take its toll on the marriage. Given the amount of unsecured debt, they were not eligible for Chapter 13. We filed a Chapter 7 followed by a Chapter 13 to address the mortgage problems. Linda went back to school to get a bachelor's degree and tutored children on the side. They managed to pay on the Chapter 13 until January 1998 when they were able to refinance their mortgage and dismiss their Chapter 13.

In short, the current bankruptcy system does help lower and middle class workers in their time of need. However, the changes proposed by S. 1301 as well as H.R. 2500 and H.R. 3150 would seriously jeopardize the ability of honest debtors to recover from financial crises. Each of the bills significantly alters the balance between debtors and creditors to the point where those most in need of bankruptcy protection could lose it based upon what seems little more than a whim of the Bankruptcy Code.

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IV. THE LIMITS ON FILING CHAPTER 7, WHETHER CHARACTERIZED AS "NEEDS-BASED BANKRUPTCY" OR "ABUSE OF THE CODE," ARE NOT DESIGNED TO ADDRESS TRUE ABUSES OF THE CODE BUT RATHER ELIMINATE LARGE NUMBERS OF DESERVING FAMILIES FROM PROTECTION FROM THEIR CREDITORS.

H.R. 2500 and H.R. 3150 employ the most transparent of methods to discourage Chapter 7 filings regardless of need. Debtors are not eligible for Chapter 7, if based upon all income or gifts received by the debtor in the last six months, the debtor had at least 75% of the national median income and they could afford to pay at least 20% of his or her unsecured debt over five years at $50 a month, after subtracting the IRS budget allowance amounts.

Merely reciting this formulation demonstrates the complexity of determining the eligibility of any debtor for relief under the Code. In addition there is no assurance that income received in the last six months is a predictor of income for the next five years. A recent case in point is the UAW workers at the Saturn Corporation. For several years those workers have operated under a contract where the compensation is a function of training, productivity, and sales. If productivity goals are met, the workers income has increased by as much as $5,500 per year or 15% of their income. These "bonuses" are calculated and paid quarterly and have ranged from several thousand dollars a year to zero.

In addition those same workers have worked extensive amounts of overtime. Again, at Saturn, that overtime disappeared overnight. However, if that income had been included in the six month calculation, the calculation would bear no relationship to reality.

That same scenario is played out every day at most auto plants around the country. As part of a cyclical industry, conditions change rapidly. One only needs to remember 1979 when literally on one day the Chrysler Corporation employed 100,000 hourly workers and the next day announced immediate layoffs that eventually totaled 40,000 hourly workers. Yet if one examined their income for the last six months, regardless of overwhelming debt and no prospects for employment, they would be disqualified from the Chapter 7 relief necessary.

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S. 1301 takes a different approach to the same issue. While this bill is more narrowly tailored and tries to use 707(b) as the method of restricting Chapter 7 bankruptcies, it also places a significant burden on the courts and debtors just to determine eligibility for filing. The revised 707(b) allows creditors to challenge any debtor's filing by claiming they have the ability to pay 20% of their debts. Lengthy challenges would result as creditors tried to prove that debtors' expenses were overstated. Courts would be mired in challenges to allowances for utility bills, clothing, and food so that creditors could label them as an "abusive debtor". Already 707(b) engenders unnecessary and divisive litigation on such things as cigarette allowances, tithes, parochial school tuition and support for dependents. The revised 707(b) would only encourage more of that litigation.

In addition 707(b) holds the losing debtor's attorney personally responsible for the creditor's attorney fees. The result is that unsecured creditors will use 707(b) to coerce reaffirmations by the threat of litigation that neither debtors nor their counsel could afford.

V. EVEN IF A DEBTOR QUALIFIED FOR CHAPTER 7 OR 13, H.R. 2500, H.R. 3150 AND S. 1301 IMPOSE BURDENSOME AND BUREAUCRATIC REQUIREMENTS, WHERE FAILURE TO COMPLY REQUIRES DISMISSAL OF THE PETITION.

Each of these bills requires the filing, on pain of dismissal, of numerous documents, prior to and during the bankruptcy, for periods of time covering as many as eight years. The most offensive of these provisions requires the filing of all federal tax returns, attachments, schedules and amendments for the three years prior to filing. In the case of Chapter 13, S. 1301 requires that all subsequent tax returns, attachments, schedules and amendments also be filed within 45 days of their due date for every year the bankruptcy is pending.

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First, many debtors do not have copies of their tax returns. If they have copies of the returns, there is no guarantee that they have copies of all schedules, attachments or amendments. S. 1301 requires that debtors produce all of those documents or the case is subject to dismissal.

Second, if the debtor does not have the return, it takes weeks, if the return is available, to obtain a copy from the IRS. In the meantime homes proceed to foreclosure, wages are garnished and cars are repossessed.

Third, these requirements would make debtors' tax returns public records, creating a potential of enormous abuse. This country relies on voluntary tax reporting and collection to a great degree. The thought that some day, if you were in financial difficulty, that your tax returns would be shared with the world, even placed on the Internet, might have very unintended consequences for our tax collection system.

Fourth, the administrative cost to maintain these records would be enormous. Based on current filings, bankruptcy courts would have to keep 4.2 million tax returns on record just in the first year. For each year thereafter the number increases as the number of Chapter 13 filings increase.

Finally the value of this record keeping is questionable since it may not assist creditors. Experience shows that incomes go up as well as down. Experience also shows that expenses always go up. Not every Chapter 13 debtor rushes to amend his or her plan if their income decreases. Few Chapter 13 debtors reduce their plans because their expenses increase. Rather than increasing the payout to creditors, this disclosure might have the opposite effect of Chapter 13 debtors seeking to reduce their payments to unsecured creditors.

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VI. H.R. 2500, H.R. 3150 AND S. 1301, IN VARYING DEGREES, PLACE SEVERE RESTRICTIONS ON THE FILING OF SUBSEQUENT BANKRUPTCIES THAT ARE WHOLLY UNJUSTIFIED AND PUNITIVE IN NATURE.

The experience of the UAW Legal Service Plans is that repeat filings are minimal, justified and more often than not successful.

In a survey of our 13 largest offices we found that for 1995 and 1996 repeat filings constituted only 8.1% of our total filings. This includes 7's followed by 13's, 13's followed by 7's and repeat Chapter 13 filings. Of the repeat filings, 91% filed twice; 9% filed three times. There were no filings in the four or more category.

The primary reason for a repeat filing was to save a home or to pay state and federal taxes. Fifty percent of the repeat filings were Chapter 13's followed by another Chapter 13. In those cases 93% were filed to save a home. The remaining 7% were to pay taxes.

The primary reasons for the dismissal of the first filing were slow payments or no payments. That was followed closely by dismissals for procedural reasons. Current Chapter 13 practice requires that payments start 30 days after filing, regardless of the date of confirmation. Many Chapter 13's are dismissed in the early stages because a wage deduction order is not implemented quickly enough or the debtor is not able to adjust that quickly to start payments. By the second filing many of those issues are resolved.

Forty five percent of those Chapter 13's were dismissed for procedural reasons. These include missing the first meeting of creditors, missing the confirmation hearing or failing to complete tax returns. Again, by the second filing many of those issues are resolved.

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Furthermore, 67% of the repeat filings occurred within the first year. Given that 91% of the total repeat filings were successful (defined as having obtained a discharge or currently in a successful payment plan), there is no basis for banning all refilings for one year regardless of the reason. Some Chapter 13's are followed by subsequent Chapter 13 because of mistakes made by mortgage companies in calculating escrow payments. Some Chapter 7's are followed by Chapter 13's because the debtors reaffirmed too much secured debt and their income changed.

This ban on refiling actually harms those debtors who are most likely to pay. Fortunes change rapidly in this country. A worker can be laid off for six months, file for bankruptcy protection and not be able to fund the Plan. Then within the next year they could be called back to work and have the ability to save his or her house from foreclosure. One need only look as far as the example of Ron E. above. Ron E. went on disability in April forcing the dismissal of his Chapter 13. He returned to work in September, refiled and has been in a successful plan since. Under each of the above reform bills, Ron E. and other workers like him would be barred from refiling and lose their homes to foreclosure.

VII. THE UAW SUPPORTS H.R. 3146 BECAUSE IT ADDRESSES ISSUES WITHIN THE BANKRUPTCY SYSTEM IN A REASONABLE AND FAIR-HANDED MANNER.

H.R. 3146 proposes a balanced approach to curbing abuses that exist within the bankruptcy system, both by debtors and creditors. It encourages debtors to make greater use of Chapter 13. It prevents abusive Chapter 7 debtors from taking advantage of state exemption laws to discharge all of their debts while maintaining personal fortunes under an unlimited homestead exemption.

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A. H.R. 3146 targets the likely source of bankruptcy abuse with a simple, fair test designed to identify debtors who have substantial income and can afford to repay unsecured creditors.

H.R. 3146 places limits on the use of Chapter 7 by debtors who can afford to repay a substantial amount of their unsecured debt. This bill correctly focuses on the likely area of abuse: debtors that have substantial income over reasonable living expenses after taking into account secured debts, priority debts, nondischargeable debts and any arrearages on those debts. The bill promotes certainty by establishing an easily calculated safe harbor test that exempts individuals with income under $60,000 from the contentious and costly litigation over who is an abuser of the bankruptcy system.

B. H.R. 3146 addresses the abuse of unlimited state exemptions while creating a level playing field for similarly situated debtors in neighboring states.

H.R. 3146 creates a level playing field in terms of bankruptcy exemptions. Currently our Delaware office services clients from Maryland, Delaware, New Jersey and Baltimore. Each of these clients work in the same factory and earn the same pay. Two of the states have adopted the federal exemptions. Maryland and Delaware have opted out and have some of the lowest state exemptions in the United States. In those states a debtor can protect $6,000 and $5,000 total of all property, including the homestead, respectively. Thus UAW workers who work together, make the same income, have the same aspirations and problems, face far different treatment under what is supposed to be a national bankruptcy law.

In addition H.R. 3146 addresses the clearly identified abuse of debtors who move unlimited amounts of money from non exempt assets into the unlimited homestead exemptions, often moving from one state to another to avoid their creditors. Neither H.R. 2500, H.R. 3150 nor S. 1301 address this most obvious of abuses clearly identified by the National Bankruptcy Review Commission.

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C. H.R. 3146 protects retirement funds and places the right priorities on the repayment of creditors.

H.R. 3146 protects retirement funds from creditors, insuring that individuals who are unable to pay their debts, do not become public charges in the future.

In addition H.R. 3146 places the right priorities on whose debts are repaid first. Bankruptcy is designed to avoid the unseemly rush to the courthouse where the most aggressive and undeserving creditor gets the largest share of the debtor's assets. Current bankruptcy law now balances the needs of the most deserving creditors and the needs of debtors to protect the property necessary to be a productive member of society. Secured creditors and priority creditors get paid first. The arrears on those debts are also paid first. Payments to single parents owed child support take priority over unsecured debt. H.R. 2500 would turn those priorities upside down. H.R. 2500 would prefer the creditor who authorized cash advances at a casino over the single mother struggling to get past-due child support payments paid.

VIII. CONCLUSION

In summary, it is the experience of the UAW that many hard working and deserving American families are placed in unfortunate, financial positions. Layoffs, loss of overtime, divorce and disability can quickly introduce financial instability into a workers' life.

These families struggle to avoid the use of the bankruptcy system. They make partial payments, borrow from friends, try credit counseling, work extra hours and multiple jobs while trying to save their credit and their homes. Over time those efforts fail, often due to the unwillingness of creditors to work with debtors and give them the second chance.

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The current bankruptcy system provides that second chance. For those debtors that can afford to reorganize and pay their creditors, Chapter 13 provides a well defined and accessible method to adjust those debts. Chapter 13 should be encouraged and strengthened to make it an even better alternative.

However, the UAW also recognizes that some debtors are exhausted financially and emotionally. They are overwhelmed by their debts and see no reasonable prospect of ever freeing themselves of the burden of 20% interest rates, late payment penalties and the threat of garnishments and levies. Those individuals need complete relief from their debts so they can start over. Chapter 7 relief relieves the emotional strain of overwhelming debt and allows them to focus on the future, with the goal of providing adequately for their families.

As a result the UAW strongly supports bankruptcy reform that accomplishes those goals. Of the four bills pending, H.R. 3146 presents the most balanced approach to the nation's current bankruptcy problems and the UAW strongly endorses its passage.

Mr. **GEKAS.** The Chair yields itself 5 minutes for questions.

Mr. Mason, the college student you talked about with the $15,000 job and so forth, do you believe in the wildest stretch of imagination that's capable of being conjured up, that he would not qualify under H.R. 3150 for a discharge of his obligations under chapter 7. H.R. 3150 I'm talking about——

Mr. **MASON.** Yes, H.R. 3150.

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Mr. **GEKAS.** Yes.

Mr. **MASON.** I believe that under H.R. 3150, he may well qualify to discharge his debts. However, in terms of portraying all debtors as abusive, I thought I would use that example.

Mr. **GEKAS.** Who has done that, may I ask?

Mr. **MASON.** I think there has been a substantial amount of testimony earlier this morning which portrayed debtors as turning to bankruptcy as a first resort, and that the credit card industry was responsible in their lending practices, and I used that example for those things.

Mr. **GEKAS.** Do you support the Conyers-Nadler bill?

Mr. **MASON.** Yes, we do.

Mr. **GEKAS.** That bill acknowledges, does it not, that there has been abuse, and its remedy is to tighten up on those sections of the Code that deal with abuse. Doesn't that mean that there are people who are abusing it? Or are they just wandering off on some Don Quixote trail?

Mr. **MASON.** No, we think that Mr. Nadler and Mr. Conyers' bill presents a responsible and a balanced approach to the bankruptcy process.

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Mr. **GEKAS.** The question is do they acknowledge abuse in the wording of their tightening up of 707 and other rules.

Mr. **MASON.** They certainly do use the word "abuse."

Mr. **GEKAS.** Then the people that you had heard before who were talking about abuse, and Mr. Nadler and Mr. Conyers were talking about abuse, are on common ground. It's simply the approach that is different, isn't that correct?

Mr. **MASON.** No, I would disagree with that. The bill under H.R. 3150 targets people whose incomes of a family of four is in the neighborhood of $37,000. The Nadler bill talks about people whose income is in excess of $60,000, plus it takes into account their actual reasonable expenses.

I've looked at the IRS guidelines for Michigan, and I reviewed one of the cases before I came here today. It allows $1200 for a home payment and utilities. One of the cases for chapter 13 that I described for the VA loan, the home payment alone was $1100, not counting utilities. Under H.R. 3150, he would have a very difficult time qualifying for the chapter 13 relief.

Mr. **GEKAS.** And you would consider that home expense might be an extraordinary circumstance that would not be contemplated by H.R. 3150?

Mr. **MASON.** My experience in bankruptcy court is that it's already a very time-consuming and litigious process. If debtors had to go and litigate every expense as to whether it's an extraordinary expense, the courts would be completely swamped with extraneous litigation the only purpose of which is to pay an extra $50 a month to certain creditors.

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Mr. **GEKAS.** Under the Conyers-Nadler bill, wouldn't the courts have to determine whether or not there's been substantial abuse, or the new abuse standards that were outlined in that bill? Wouldn't the courts have to do that?

Mr. **MASON.** The courts would have to determine whether or not there was abuse, but the group tested is much more limited. The Conyers-Nadler bill more narrowly targets people who are more likely to be the abusers of bankruptcy, those with substantial incomes.

Mr. **GEKAS.** Mr. Mason, one other question. I need a yes or no, so I can move to the others.

Mr. **MASON.** Certainly, Mr. Chairman.

Mr. **GEKAS.** The auto plants that you're talking about.

Mr. **MASON.** Yes.

Mr. **GEKAS.** Are those workers members of credit unions?

Mr. **MASON.** Yes.

Mr. **GEKAS.** Now, Mr. Sommer, you were talking about something extraordinary happening in a situation, like a layoff or extraordinary expenses and so forth. Do you believe that H.R. 3150 does not take into account, even for the lowest income person, the advent of a layoff or extraordinary expenses?

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Mr. **SOMMER.** Well, H.R. 3150 does have a provision dealing with extraordinary expenses, but no allowance for a change in income. And the problem is, it is the debtor's burden to raise extraordinary expenses in every case.

Mr. **GEKAS.** What is wrong with that?

Mr. **SOMMER.** Well, what's wrong with it is it's going to increase the—I mean, the standardized expenses of the IRS standards are so narrow that probably most debtors have what would be called extraordinary expenses, and we're basically adding a tremendous burden, first of all, on debtors to raise that in every case. And then second, giving creditors without any income floor the right to just object; they don't even have to show up in court.

If the creditor files an objection, the debtor has to go to court, lose a day's work, pay a lawyer hundreds of dollars that the debtor may not have in order to just proceed with the process on an expense that——

Mr. **GEKAS.** But it could be done.

Mr. **SOMMER.** Well, in many cases, it couldn't be, because the debtor couldn't afford a lawyer, and the debtor would be stuck——

Mr. **GEKAS.** How would the debtor get as far as he did under your hypo without a lawyer?

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Mr. **SOMMER.** Many debtors file pro se.

Mr. **GEKAS.** Yes.

Mr. **SOMMER.** Many debtors can afford the minimal fees, or the relatively reasonable fees of chapter 7 today. One of the things about H.R. 3150 is that the additional paperwork that would be involved, getting the debtor's tax returns from IRS, getting all these addresses, trying to figure out the correct address to use for the creditor from the last communication, which, of course, the debtor doesn't have, is going to add hundreds of dollars to every debtor's attorney's fee.

Mr. **GEKAS.** Mr. Shulman, the single mother that you were talking about that you see quite often, do you believe that that person would automatically be disqualified from relief under H.R. 3150?

Mr. **SHULMAN.** What I've seen is, I've seen single mothers who are—or single wage earners, it could be the father.

Mr. **GEKAS.** Yes, all right.

Mr. **SHULMAN.** They're in chapter 13 plans, something happens during the time with one income. If they get laid off, they lose the job, the case got dismissed.

Mr. **GEKAS.** Yes.

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Mr. **SHULMAN.** In those cases, I've been able to, after four months, they got another job, I go back in and file a new 13, which wouldn't be allowed in these cases. They complete the payment plan. Maybe it was a tax case or a car case, they needed to get paid. And the creditors didn't come off any worse. But I see all of those people being harmed. What happens is, there's no flexibility here.

Mr. **GEKAS.** Don't you see in H.R. 3150 the prospect of exactly the same hypothetical that you gave and chapter 13 wasn't working, that they could revert back to chapter 7?

Mr. **SHULMAN.** Title VII wouldn't have solved those clients' problems. They needed to pay off a debt that wouldn't be discharged, where they would have lost an important asset like a vehicle.

Mr. **GEKAS.** Well, in what way does it differ, then, from the current law?

Mr. **SHULMAN.** The current law allows me to do a refiling without having to go through costly barriers for the debtor. And the creditors have the right to object to a refiling where there's abuse involved, but if my client's acting in good faith, it doesn't cost them a lot more of my time to prove the legitimacy of their claim.

Mr. **GEKAS.** And you're saying H.R. 3150 does not accord that relief?

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Mr. **SHULMAN.** Yes.

Mr. **GEKAS.** I went over time. I did want to ask Ms. Russell a question.

Mr. **CONYERS.** I'll give you some more time.

Mr. **GEKAS.** I will yield to you. We'll recognize the gentleman from New York, or if he wants to, Mr. Conyers.

Mr. **NADLER.** I'll yield to the gentleman from Michigan. All right, well, reclaiming my time, which hasn't started yet, I hope.

Let me ask Mr. Shulman, Mr. Shulman, in your testimony you say that under H.R. 3150, the needs based test combines phantom income with expenses which have no connection with real expenses of the debtor. What do you mean by phantom income?

Mr. **SHULMAN.** What I mean is that the debtor who shows up at my door to determine their eligibility for chapter 7 or their ability to pay under chapter 13, I don't look at what they're making at that time, or what they made the last month where they just landed a job. I have to look at——

Mr. **NADLER.** Under H.R. 3150, you look at.

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Mr. **SHULMAN.** Under H.R. 3150, I would have to look at whether their brother or sister or family member gave them support for a couple of months on a temporary basis only.

Mr. **NADLER.** And then you would have to assume that they would continue to give them that support for the next 5 years.

Mr. **SHULMAN.** H.R. 3150 presumes that that income is the income available to pay their bills today.

Mr. **NADLER.** For the next 5 years.

Mr. **SHULMAN.** It also presumes that the income from a higher paying job that they may have lost forever four months ago, and they just landed on their feet at a low-paying job, that that income is currently with them.

Mr. **NADLER.** Wait a minute. So I'm working for AT&T and along comes, I forget his name, the slasher, and lays off 40,000 people, and I'm one of them. So I lose my $50,000 a year job and now I get a $20,000 a year job. H.R. 3150 assumes I have an income of $50,000?

Mr. **SHULMAN.** No. It assumes if I got that new job within six months, which I sure hope I did, that the months that I earned $50,000 a year, I had a $4200 a month income, which is averaged in with the income for the other months during that period.

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Mr. **NADLER.** So, in other words, it takes the $50,000 and the, whatever the other one was, and it averages them.

Mr. **SHULMAN.** It averages them, even though I'm, right now, not in an average position. I'm where I really am.

Mr. **NADLER.** I see. Let me ask you, someone who's thrown out of chapter 7 under current law—rather, how does current law throw people out of chapter 7 if they have the ability to pay their debts?

Mr. **SHULMAN.** A trustee or the U.S. trustee will bring a substantial abuse motion under 707(b) and the court will rule on that.

Mr. **NADLER.** And they can take into account future earnings?

Mr. **SHULMAN.** The substantial abuse test isn't defined very well today, and some cases can take that into account.

Mr. **NADLER.** And under our bill, which defines abuse?

Mr. **SHULMAN.** I think that the benefits, and the reason NACBA is supporting your bill is because we recognize that judges need a little bit more guidance. They need a clearer path to determine what is disposable income. We don't object to that. But they don't need a brand-new system of determining income and expenses, which isn't going to take into account the actual income and expenses for an individual case.

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Mr. **NADLER.** Let's talk now about the means test. The argument for this means test is that 707(b) gives courts the power to kick people who can repay their debts out of chapter 7, to go into chapter 13 for reorganization plan.

Our bill says let's increase that power, and more specifically, define it. There is some abuse, we recognize that, and let's give the courts more defined power to alleviate that abuse.

Given that fact, what's wrong with having a more precise test, one you can put into a computer and get the same answer each time, so you don't have to go before a judge each time, you don't have to waste everybody's time and money going before a judge. You just put it into the computer. We know what the income is, we know what the average is, and it's chapter 7 or it's chapter 13. That's the Gekas Bill. What's wrong with that?

Mr. **SHULMAN.** Well, the human beings that come into my office aren't cookie-cutter people. Some of them have tithing expenses, some of them are supporting an elderly mother in Montana who's on $300 a month Social Security.

Virtually everyone that I see in Santa Clara County, California would have housing expenses that would be outside the IRS guidelines. They'd lose their homes.

Mr. **NADLER.** Because Santa Clara, California is above the national average cost of living?

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Mr. **SHULMAN.** It's far above the national average.

Mr. **NADLER.** And this bill doesn't take into account regional cost differences in the cost of living.

Mr. **SHULMAN.** And the sponsors might say, "Well, that's an extraordinary expense." Well, the cost of going into court on every one of those cases would be prohibitive for debtors, and it would ultimately lead to a lower recovery for the creditors.

Mr. **NADLER.** Because?

Mr. **SHULMAN.** Because if the attorney for the debtor is going to be paid as an administrative claim, which is where it comes from in chapter 13, the dollars that are left on the table for somebody else are going to diminish.

Mr. **NADLER.** Let me ask you one last question, because I see the yellow light is on. Under the Gekas bill, under H.R. 3150, if after deducting expenses, a debtor has left more than $50 per month and sufficient funds to pay 20 percent of nonpriority, unsecured debts over 5 years, he must file chapter 13.

Couldn't a debtor evade this test by running up some debt, pre-petition, so that he couldn't make the 20 percent? Couldn't a dishonest, even well-off debtor evade this? Wouldn't this provision catch only the unsophisticated, poorly advised honest debtor?

Mr. **SHULMAN.** I think that that answer was given earlier by Judge Newsome, who cited one of his case studies, where the debtor who had the highest income and the largest amount of unsecured debts would pass the H.R. 3150 test; whereas most of the working class people wouldn't.

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Mr. **NADLER.** Thank you, Mr. Chairman. Thank you.

Mr. **GEKAS.** The gentleman from Michigan.

Mr. **CONYERS.** Thank you, Chairman Gekas.

Let me welcome all the panelists. This is probably as good as we're going to get in this operation this afternoon, and we appreciate you all being here.

Ms. Russell, in her very personal and moving testimony, mentioned that there were certain problems connected with filing for chapter 7. And there are other implications that somehow or other, chapter 7 is cost-free or it's a convenient way out.

And I wanted to ask you gentlemen to try to give us some feeling for chapter 7, because it might be that unsophisticated debtors may be getting into a problem that they're not quite aware of.

Anyone want to try to talk about that?

Mr. **SOMMER.** Well, I think lawyers should, and I'm sure in most cases, if not all, they do advise their clients about the consequences of filing. I don't know exactly what Ms. Russell's lawyer told her. We know he told her about the effect on credit, but she didn't really totally understand it.

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People who file chapter 7, I think, as has been said, are very aware of the stigma that attaches, and which Ms. Russell felt. And I think it is simply a myth that they are not aware of that. If anything, the one thing that has changed in the last five or 6 years, I would say, is when people used to ask me—and this was their primary concern, as Mr. Mason said—can I get credit after I file for bankruptcy. I used to tell them no.

To be perfectly honest, and I try to be honest with my clients, the answer now is yes. That's something that has changed in the credit industry.

Mr. **CONYERS.** Welcome from Detroit, Mr. Mason. We appreciate your comments. Do you have anything to add to this chapter 7 business?

Mr. **MASON.** Not on the chapter 7 business, but if I might digress for a moment and talk about the repeat filing problem and what I see really as the major problem with H.R. 3150 and H.R. 2500.

It seems to me that the bills—and I think it's an unintended consequence—set up debtors for failure. Essentially, it imposes significant barriers to filing in the first place. If you are fortunate enough to be able to qualify for either one of the two chapters under the bill, it includes significant procedural requirements, which, upon of pain of dismissal if you don't comply, you're out of the bankruptcy system.

And then to add the final touch to it, it bars refilings within a single year.

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So, as I see the system—and I think it's an unintended consequence of the bill—is that in the rush to reduce the total number of filings, the raw number of filings that have been going up, we have managed to craft a bill that is aimed at reducing filings without targeting the real problems with abuse.

That is the primary reason why the UAW does not support those bills and does support the Conyers-Nadler bill. Conyers-Nadler is a much more narrowly targeted bill, trying to focus on debtors with larger incomes who are more likely to be potential abusers of the system.

Mr. **CONYERS.** Thank you.

Ms. Russell, can you just recapitulate some of your feelings about chapter 7. I was in and out during your testimony. I didn't hear it. How do you view it now from your perspective?

Ms. **RUSSELL.** At the time, it was the right choice for me, because I didn't have the income or any assets to take care of the bills that I did have. But I did incur those debts. Now that I got in the same situation, I'm glad that I chose to pay them back. It feels a lot better.

I had no idea the impact that chapter 7 would have. I thought it was just going to be on my credit report. And I thought, okay, I can survive that on my credit report. I didn't know that it was going to affect my job, my rent, a checking account.

Mr. **CONYERS.** Your credit rating.

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Ms. **RUSSELL.** Yes, everything. I've never had a car payment. I've never had a new car. I don't know when I'll be able to have a home.

Mr. **CONYERS.** Do you have a family?

Ms. **RUSSELL.** Yes. I have three kids.

Mr. **CONYERS.** Wow. Well, let me ask you, would there have been another alternative—if another alternative had been put to you that was legal, would you have considered that?

Ms. **RUSSELL.** Absolutely.

Mr. **MASON.** If I might respond. The difference in terms of how chapter 7 and chapter 13 are treated by creditors is not significant. The fact that a repayment plan—and that is one of the things that was brought before the National Bankruptcy Commission as one of the main critiques of the credit industry—they do not distinguish between a chapter 7 and a chapter 13 for purposes of extending credit.

And so if she had chosen a 13 to get out of her problems, there's no likelihood that the results would be any different.

Mr. **CONYERS.** Thank you very much. Thank you, Chairman.

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Mr. **GEKAS.** We thank the gentleman. We turn to the gentleman from Massachusetts for the customary 5 minutes.

Mr. **DELAHUNT.** Yes, thank you, Mr. Chairman.

Mr. Sommer, you just said something that really struck home. Currently—and correct me if I'm wrong—you made the statement that even if you go through bankruptcy, it isn't that difficult to get credit. What kind of credit are you talking about?

Mr. **SOMMER.** Mostly, what I'm talking about is what has come to be called the subprime market, which is a high-interest mortgage, high-interest credit card market, which has really grown in the last 6 or 7 years.

It's the type of credit that unfortunately is often offered to people in the inner cities by lenders who we call predatory lenders, because we think they prey on peoples' lack of access to other creditors. But it's a high-rate lending that often causes people to have additional financial problems because the interest rates are so high.

Mr. **DELAHUNT.** And it's readily available today.

Mr. **SOMMER.** I represent mostly low-income people with incomes in the hundreds of dollars a month, and they are getting credit card offers after bankruptcy.

Mr. **DELAHUNT.** Well, that's an interesting question. Earlier, I think it was the second panel, there was a divergence of views between Mr. Cutler and Judge Newsome. Now, were you here listening to that particular testimony?

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Mr. **SOMMER.** Yes, I was.

Mr. **DELAHUNT.** And I presume you remember my own observations and questions. Would you care to comment?

Mr. **SOMMER.** Well, I think that we all know that the cost of funds for creditors has gone down substantially. The average rate on credit cards has hardly gone down at all. That makes it a lot more profitable to do credit card lending, and it means you can take more risks and extend credit to a wider range of people.

The creditors seem to be competing on something other than rates for those people.

Mr. **DELAHUNT.** Well, that's my question, because Mr. Cutler raised the issue, and he certainly is more learned than I when it comes to economics. He's sitting there and I'm sitting up here, so I think that's valid evidence of that statement.

But the reality is that I haven't noticed—and maybe Mr. Mason or somebody on this panel can comment—has there been a proportionate decline in credit card interest rates over the past decade, for example, as we have seen other rates decline?

Mr. **SOMMER.** No, there has not been. I think it's well-documented. I think Professor Ausubel, who might be testifying on the next panel, is more of an expert than I on the subject. But I think it's been well-documented.

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Mr. **DELAHUNT.** Well, what's happened? Why hasn't competition worked?

Mr. **SOMMER.** I think the main reason is that people, for better or worse, and probably due to the lack of consumer education, do not shop for credit card rates, or they're enticed by teaser rates sometimes. But people do not shop for rates, and the competition is about frequent flyer miles or——

Mr. **DELAHUNT.** But is there any credit card company out there today that is offering a rate that is significantly lower than, if you will, the—how shall I say—the norm in the industry?

Mr. **SOMMER.** Yes, there are credit card companies that offer lower rates.

Mr. **DELAHUNT.** Such as? Let's give them a plug. This might be the beginning of a consumer education initiative.

Mr. **SOMMER.** I don't know that I can give you a name. I know some——

Mr. **NADLER.** Will the gentleman yield?

Mr. **DELAHUNT.** I yield.

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Mr. **NADLER.** Wachovia Bank.

Mr. **DELAHUNT.** Wachovia Bank. Everybody should be writing that down.

Mr. **SOMMER.** There are credit card companies that offer different rates to different people, too.

Mr. **DELAHUNT.** Different rates for different people? Could you expand on that for me?

Mr. **SOMMER.** Well, I think they have different levels of rates, depending on how much your income is, how much debt you have. With some of them, if you have more debt, you get a lower rate.

Mr. **DELAHUNT.** More debt, lower rate. That just doesn't compute for me, but again, I guess I'm having difficulty grasping this particular subject area.

I'll yield to my friend from Michigan who I see is ready to pounce.

Mr. **CONYERS.** Would the gentleman yield?

Mr. Chairman, if I could get a minute more onto Mr. Delahunt's time. I was just wondering if any of the witnesses in this panel are aware of the possible increased costs of the bankruptcy system if the bill that our Chairman is promoting actually became law.

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Mr. **SHULMAN.** Yes, Representative Conyers. I am aware of a study that has been done by the chapter 13 trustee who administers the bankruptcies in the San Jose Division of the Bankruptcy Court. And I think that study is right now in the hands of the U.S. Trustee's Office, and it may be available.

Mr. **CONYERS.** Is it public?

Mr. **SHULMAN.** I don't know whether it's been publicized or not yet, but that study showed that her costs would almost double from administering all of the mechanisms for annual reviews of debtors' income and expenses, tax returns, virtually everything that's laid out here. That the costs would approximately double for her office, and the return for unsecured creditors would diminish, I think it was by $1.5 million per year.

And that wasn't factoring in the costs from representatives such as attorneys. On a typical case, the most time-consuming thing I do when I interview the debtor is to work out the budget, find out really how much income can be counted on each month, how does it fit in, how can their living expenses be covered. I do that normally once in the case.

Under H.R. 3150, I would do that an additional four times—each year on the anniversary of the plan, at a minimum.

Mr. **CONYERS.** Well, thank you very much. It's a part of these bills before us that we'll have to look at quite carefully. And I thank everyone for joining us.

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Mr. **DELAHUNT.** Mr. Chairman, can I ask unanimous consent to ask one more question.

Mr. **GEKAS.** Without objection.

Mr. **DELAHUNT.** You know, I think the thing that I find personally offensive is the wealthy individual who ends up in a State—I think Florida is one of those states, where they go and they purchase a primary residence and it's in Palm Beach and it's overlooking the ocean and the cost is $10 million or $11 million, and they have this unlimited exemption.

I think, you know, I would expect that everybody on this panel finds that particularly disturbing. How do the two proposals handle that so-called unlimited exemption?

Mr. **SHULMAN.**H.R. 3150—and it was actually inaccurately portrayed before—says that you cannot take an exemption for the place unless you have lived there the greater part of 1 year, which is six months and one day, not 1 year, which is what was said before.

The Conyers-Nadler bill says that you cannot claim the exemption above $100,000 if you have transferred property into that—transferred assets into that unlimited exemption within a year before the bankruptcy.

Mr. **DELAHUNT.** I would comment that neither one of those bills would meet my test. I think you ought to be talking about 4 or 5 years rather than a year or half a year.

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Mr. **CONYERS.** We'll be glad to entertain an amendment when the time comes.

Mr. **GEKAS.** The gentleman's time has expired, and the time of the witnesses has expired. We thank you very much. You gave us a lively exchange here, and very valuable in the overall context of what we're attempting to do.

Thank you very much.

Mr. **MASON.** Thank you, Mr. Chairman.

Mr. **SHULMAN.** Thank you.

Mr. **GEKAS.** The final panel will now take its place at the witness table, which will include Stuart Feldstein, President and Chief Executive Officer of SMR Research Corporation of Hackettstown, New Jersey.

Since 1984, Mr. Feldstein has been President and Chief Executive Officer of SMR, which is the nation's largest publisher of market research studies on consumer loans, consumer credit risk, bankruptcy and financial demographics. Last year, SMR published a comprehensive state-by-state analysis of the demographics, causes, implications and solutions regarding consumer bankruptcy. Prior to joining SMR, Mr. Feldstein was the editor of the Corporate Strategy Section at Business Week.

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Mark Lauritano joins us. He is the Senior Vice President of Resource Planning Service of the WEFA Group. Mr. Lauritano will address the macroeconomic costs of our present consumer bankruptcy system and report on the results of a recent study his firm has just released. WEFA is an economic consulting firm, founded by Lawrence Klein, a Nobel Laureate from the University of Pennsylvania.

Professor Lawrence M. Ausubel is a Professor of Economics at the University of Maryland. He received his A.B. from Princeton in 1980, his Ph.D. in Economics from Stanford in 1984. He has authored numerous articles on the subject of credit cards.

We will begin, as in previous panels, with the assertion that the written statements, of course, will become a part of the record. The oral statements of the witnesses would be limited to 5 minutes. And we will proceed in the order in which they were announced, with Mr. Feldstein being number one.

STATEMENT OF STUART A. FELDSTEIN, PRESIDENT, SMR RESEARCH CORPORATION

Mr. **FELDSTEIN.** Thank you.

SMR Research is a publisher of market research studies on consumer loan markets and related subjects like bankruptcy. We're projecting right now that personal bankruptcies in 1998 will reach 1.46 million. That number would be double the number of 4 years earlier in 1994. Bankruptcies per capita have been rising annually since 1985, with only 2 exceptional years.

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One of the assets we have at my firm is a database, we believe the only one of its kind, of personal bankruptcy filing rates per capita by county, by city, by state, and nationally, with a history going back to 1989. We can look at these figures and look at what other economic data might correlate with them to help explain what's causing this serious problem.

One thing we have surely found is that while it would be very convenient to blame bankruptcy on just one thing, you really can't. There are multiple reasons for this surge in bankruptcy. We have categorized them into three groups.

First, there are financially catastrophic events, something we haven't really heard much about during the testimony today. These are things that cause consumers' debts to increase, often sharply, sometimes suddenly, without any concurrent increase in income.

One of these, for example, is the steady increase we've seen in the percentage of adults who are divorced. Back in 1965, 2.9 percent of Americans adults were divorced. According to the Census Bureau, that's now up to 10 percent, and is mathematically certain to continue to increase.

Another problem is that we have some 40 million Americans lacking health insurance, which is at or near an all-time high. Certainly, the cost of medical care is at an all-time high. All these people are in financial jeopardy if they get seriously ill or injured.

There is, meanwhile, the spread of casino gambling. The American Gaming Association disagreed with us publicly that there is any connection between gambling and bankruptcy, but you can see the evidence on the map. The closer you get to gambling centers, the higher the bankruptcy rate.

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And the average filing rate in counties that have major gambling facilities within them, the average filing rates are higher than in places that don't have them. Besides, I've done a lot of hands-on research and have found that the odds favor the house.

Two more things, there are about 25 million Americans——

Mr. **DELAHUNT.** Have you filed, Mr. Feldstein?

Mr. **FELDSTEIN.** Not yet, thank you. There are about 25 million Americans driving cars without insurance, and finally, although we really don't have good numbers on this issue as yet, we believe there has been a significant increase in the last few years in entrepreneurial self-employment, which is high-risk activity.

So these are potentially catastrophic events. Bankruptcy is an actuarial result. Some small percentage of people in these high-risk groups will get unlucky, act irresponsibly, whatever, each year. So as the high-risk groups get larger, so will bankruptcies. That was category number one.

A second category is financial debt. It is absolutely true that consumer loan debt has moved up strongly in the 1980's and 1990's, and that has been bad for bankruptcies. However, we believe that the connection between debt and bankruptcy is often misunderstood. We also think it's not as close a connection as it used to be.

Consumer debt rose strongly, for example, in 1993 and 1994, but bankruptcies fell in those 2 years. Consumer debt is now rising at a much more modest pace, and yet bankruptcies are going through the roof. So the connection is getting a little bit muddy.

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Also, I would like to point out that despite the high visibility of aggressive credit card marketing, something we've heard so much about today, the vast majority of the debt increase in this country has been in housing, not credit cards.

If you just open up your monthly Federal Reserve Bulletin, which I'm sure is on all of your coffee tables back home, you will find that over the last 10 years, residential mortgage debt has risen about $2 trillion, while credit card and related debt has risen $375.8 billion. Those are just Fed numbers.

If you add to housing debt a pro forma amount for renters, which the Fed doesn't count as being debt, and yet they do have to pay every month, then the total housing debt becomes now, today, around $6.2 trillion, which is more than 12 times the size of credit card debt.

There are two other problems with debt, I think sometimes overlooked. One of them is the existence of large amounts of adjustable rate debt. At the beginning of the 1980's, there wasn't any, not a penny of it. Now we have more than $1.5 trillion worth of adjustable rate debt, most of it mortgage debt, meaning that for millions of Americans, their monthly loan payments can rise or fall beyond their control at any time.

The second big problem is in credit cards, where we believe issuers are often wrongly blamed for causing the overall debt increase. But what they have done is increase enormously the total amount of unused, but approved, credit lines. These have nearly doubled to $2 trillion just since 1993.

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The third category—and I'll wrap up—is decline in social stigma. Stimulating that, we think, is lawyer advertising, once rare, but now common and provocative.

Yes?

Mr. **GEKAS.** You said—I'm sorry, it was mumbled. You said unused——

Mr. **FELDSTEIN.** There has been a tremendous increase, not so much in outstanding credit card debt, but in the amount of approved, but unused, credit card lines, the lines available to people.

[The prepared statement of Mr. Feldstein follows:]

PREPARED STATEMENT OF STUART A. FELDSTEIN, PRESIDENT, SMR RESEARCH CORPORATION

INTRODUCTION

Personal bankruptcies exceeded 1.3 million in 1997—a new record by far. The 1997 filings were up more than 200,000 from 1.1 million in 1996, which also had set a record. These recent annual increases alone are larger than the total number of bankruptcies was in the early 1980s. In 1998, the number of personal bankruptcy filings is highly likely to be double the level of just four years earlier; there were 773,117 filings in 1994.

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Clearly, we are in the midst of a wild and unprecedented escalation in personal bankruptcies. Bankruptcy filings per capita have been rising each year since 1985, except for two years (1993 and 1994). Since 1995, the pace of the increase has become explosive—surprisingly, since the national economy is in such good shape.

Unemployment is very low and jobs are growing fast. Inflation-adjusted personal incomes are rising, homes are selling in record numbers, inflation seems under control, consumer confidence is high, and banks' commercial loans are showing extremely low loss rates. How could it be that in the middle of such prosperity, we could have two consecutive years of recordsetting personal bankruptcies, almost surely to be followed by another record in 1998?

We believe there are multiple reasons for this. They make the problem more complex than some observers think when they lay the blame on just one causative factor or another. Our research shows that the causes of the bankruptcy increase can be put into three groups:

First, there has been an increase in the frequency and the cost of certain financially disastrous events that happen to people. These events can happen solely due to bad luck, or they can be the direct result of an individual's behavior. Among these problems are divorce, lack of health insurance, the rampant spread of casino gambling, driving without auto insurance, and an increase in entrepreneurial self-employment.

Second, there are three problems related to consumer debt: (1) Actual debt owed by people has grown, (2) There has been even faster growth in the amount of unused but available consumer credit lines, and (3) Since the early 1980s, consumers have amassed a great deal of adjustable rate debt, meaning that interest rate movements now change monthly loan payments.

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Third, we believe there are non-financial issues behind the bankruptcy increase, including greatly increased lawyer advertising and a reduction in the social stigma once associated with bankruptcy. Only these intangibles seem available to explain why bankruptcy is growing even faster than all the other reasons previously described.

This paper also deals with what we believe to be some common misperceptions about why bankruptcies have increased. Finally, it touches on the impact of rising bankruptcies on solvent consumers and on financial institutions.

THE RISE IN ECONOMIC DISASTERS

In 1986, SMR first postulated the theory that bankruptcies were increasing, at least in part, because of an increase in the frequency or severity of so-called "insolvency events." These are financial disasters that cause family debts to spike suddenly, destroy savings, or otherwise change the monthly income to debt ratio.

We developed this theory by looking at our state and local area bankruptcy filing rates per capita and then searching for correlating data sets that would explain why some places are so very much better or worse than others in filing rates. Since 1989, SMR has been collecting data on the numbers of bankruptcies filed in each U.S. county, metro area, state, and nationally, and we divide these numbers by population for a per capita bankruptcy filing rate, allowing all places to be compared fairly.

One problem is divorce. Although the annual rate of divorce is now a bit lower than at its peak in the 1980s, there has been a steady, inexorable increase in the percentage of adults who, at any moment in time, happen to be divorced. Census data show that in 1965, only 2.9% of American adults were divorced, and this number has now ballooned to about 10% of all adults 18 and older. Because the annual rate of marriage is only about twice as high as the annual rate of divorce, the percentage of adults who happen to be divorced is mathematically certain to continue to rise, ultimately to 15% or even 20%, barring some major change in how well people get along.

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There are some obvious financial problems that come with divorce. Two people who had one monthly housing bill suddenly have two, and they have legal bills to pay, and possibly new child care costs, plus alimony and child support payments that in some cases puts a financial strain on one spouse or the other. In some cases, the worst thing that can happen is to be awarded the family home and car—and the monthly payments that go along with them. Divorce does not necessarily cause financial disaster immediately, but can do so years later when savings are finally depleted or mandated alimony or child support payments become too great to bear.

We find that per capita bankruptcy filing rates and divorce rates match well at all geographic levels tested—even county by county across the country. Credit managers are well aware that divorced people in general have greater credit risk than married people, however fair credit laws prohibit the use of marital status as a criterion for granting credit.

Another, and potentially greater, economic disaster strikes when people become seriously ill or injured and either don't have health insurance or else don't have enough of it.

The Census Bureau reports that some 40 million Americans have no health insurance of any kind, including any government program, and this number is at or near a peak for modern times. Even if this number were not at a peak, the rise in the cost of medical services would put uninsured people at greater risk of default than they used to be. Again we find general correlation between state-level bankruptcy rates and percentages of the population lacking health insurance as reported by the Census. Places with very high bankruptcy rates often have high percentages of uninsured people, and places with low bankruptcy rates almost never have large percentages of the population lacking health insurance. Various surveys done over the last two years of bankruptcy filers consistently show that 20% or more of them cite medical debt as a major contributor to their defaults.

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Car insurance is another problem. Using the midpoint of two insurance industry estimates, it appears that some 25 million Americans now drive cars without car insurance. In some states, doing that is within the law, and in most of those states, the bankruptcy rate is very high, including Tennessee and Alabama.

The spread of casino gambling also appears to be a problem. When we look at bankruptcy rates in counties that have major gambling facilities in them, those rates are higher than in counties that have no gambling facilities. According to the American Gaming Association, U.S. households made a record 154 million visits to gambling casinos in 1995—an increase of 235% over five years. On the county map in Nevada, the closer you come to Las Vegas and Reno, the higher the bankruptcy rate generally gets. In California, the highest bankruptcy rates typically are in San Bernardino and Riverside counties, which are the closest to Las Vegas, and the fourth highest rate often is in Sacramento County, closest to Reno. In New Jersey, Atlantic County, which is where the casinos are, typically has either the highest bankruptcy rate or one of the two or three highest in the state. In Tennessee, the bankruptcy rate is highest in Shelby County, the heart of Memphis, which is right across the state line from the Tunica MS casino gambling complex, reportedly the largest outside of Nevada.

The AGA has officially expressed disagreement with our view that gambling is a contributor to bankruptcy. We respect their opinion; we were under the impression that in casinos, the odds favor the house and people sometimes lose. As the number of gamblers increases, so would the likelihood that some people lose a lot.

Indeed, with all the risk factors just cited—lack of health insurance, divorce, driving without insurance, and gambling—the bankruptcy problem is actuarial. The vast majority of people who gamble will gamble responsibly. Most people without health insurance will be lucky and avoid serious injury or illness. Most divorced people will find a way to handle the financial strain. The problem is that if only 1% of these growing high-risk groups have a problem, they could account for at least 500,000 bankruptcies per year.

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CONSUMER DEBT: PROBLEMS AND MISCONCEPTIONS

One widely held belief about bankruptcies is that they have increased purely because people have more financial debt than they used to have. And, in some news articles about bankruptcy, the aggressive marketing of credit cards has been blamed as the prime culprit in this debt spiral.

There is certainly some validity to the notion that increased loan debt is related to the increase in personal bankruptcies. However, the relationship between these two events has not been very strong in the 1990s, and we think there are some fundamental misunderstandings about what the connection really is between debt and bankruptcy.

Both consumer debt and bankruptcies have increased in the 1980s and 1990s. But the lion's share of the debt increase hasn't been in credit cards; it's been in housing debt. All one needs to confirm that is a quick glance at the monthly Federal Reserve Bulletin, where the tables regularly break out consumer debt by category.

We can compare the most recent Fed figures for 1997 to the same debt categories 10 years earlier in 1987. (Or, you can compare the current numbers against any other year in recent history and reach the same conclusions.)

In 1987, the total dollars owed on residential mortgage loans were $1.959 trillion, and the total dollars owed on all forms of non-real-estate revolving debt (credit card, unsecured personal lines, and checking account overdraft loans) were $153.9 billion. In 1997, the total dollars owed on residential mortgages were $4.027 trillion, and the total owed on all revolving debt had reached $529.7 billion.

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So, over the 10 years, mortgage debt increased by more than $2 trillion and credit card and related debt increased by $375.8 billion. Put another way, the dollar increase in the mortgage category was more than five times the size of the increase in the credit card category.

Furthermore, even these numbers understate the difference. When the Fed looks at housing debt, it only counts mortgage loans. It does not count the housing payments made by renters as being "debt." And yet, renters must make those payments every month, just as homeowners must pay their mortgage loans, and rents are higher today just as mortgage debt is higher. When you combine residential mortgage debt with a pro-forma debt amount for renters, what you find is that today, total housing debt is around $6.2 trillion—more than 10 times the size of total credit card debt.

SMR has no hidden agenda in making these observations. We have some clients in the credit card business but a lot more clients in real estate lending who may cringe to see us make these comments. It just happens to be true that most of the consumer debt in this country is housing debt, not credit card debt, and the real estate debt also is what has been increasing most rapidly by far.

This means that it's very hard to be honest and blame the bankruptcy mess on aggressive lender marketing techniques. The increase in housing debt has come as a result of more people buying homes, and the escalating prices of homes. Also, mortgage lenders, for a variety of reasons, now tend to make loans at higher ratios to the values of properties than they used to do. It's not the mortgage lenders stuffing your mailbox with offers to finance your next home purchase; indeed, mortgage lenders cannot make wild offers of credit since they must first do appraisals, title checks, and other lengthy underwriting. The credit card issuers are the ones engaged in heavy marketing, yet we've just seen that their portion of total debt is small and the increase in card debt pales in contrast to housing debt. These facts call into question the notion that hyper-aggressive credit card account marketing is behind the bankruptcy spike.

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Moreover, there are reasons to think that although levels of consumer debt are certainly related to bankruptcy, the entire connection is getting a little weak, and something else is also going on.

For example, in 1993 and 1994, total consumer debt continued its normal rate of increase, but bankruptcies declined significantly. From 1995 through 1997, the rise in consumer debt moderated, but the bankruptcy rate exploded. By our estimate, the U.S. consumer debt-to-income ratio actually improved in 1997 over 1996, mainly because incomes got better, and this happened just as bankruptcies reached a new record high.

Further, consumer debt to income ratios fail to correlate with bankruptcy rates at the state, MSA, or county levels as shown in our database. The greatest single variable in the consumer debt load from one state or locale to another is the cost of housing; it is the largest piece of debt and annual housing costs can vary by three-fold from one place to another, like California versus Mississippi.

But many places with reasonably low ratios of debt to income also have some of the nation's highest bankruptcy filing rates—like Tennessee, Alabama, and Mississippi. Other states not so distant from these have low d-t-i ratios and low bankruptcy rates, like North and South Carolina. There are states with high d-t-i ratios and high bankruptcy rates, like California, Oregon, Nevada, and Virginia, and states with high d-t-i ratios and much lower bankruptcy rates, like Delaware, New Hampshire, and Maryland. In short, it's very hard to see any pattern at all in these data.

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There are two other aspects of consumer debt that probably do play a role in bankruptcy. One is adjustable rate debt and the other is debt that's unused but available to consumers.

I noted earlier that bankruptcies fell in 1993 and 1994—the only two years out of the last 12 when that happened. How come? The only explanation we know of is interest rates and adjustable debt. As recently as 1980, there was literally not a dollar of consumer debt with an adjustable rate. Today, we estimate that more than $1.5 trillion of adjustable rate consumer debt exists, most of it comprised of adjustable rate mortgages. This means that when prevailing interest rates rise, monthly debt payments rise later (often lagging one year) for millions of Americans, and when interest rates fall, monthly payments get easier. In 1993 and 1994, bankruptcies fell after interest rates had declined very significantly, and then rates went back up rather dramatically in later 1994 and in 1995, followed by a bankruptcy surge.

Finally, there's the matter of *available* debt. I said earlier that credit cards cannot be blamed for the rise in total consumer debt, but what they *have* done is dramatically increase the credit lines that are available to people who may get in financial trouble for other reasons.

In mid-1997, we tallied the total extended credit card lines of all U.S. banks at yearend 1996, using bank call and income regulatory reports and other data, and the number was $1.78 trillion. That was nearly double the amount of 1993, just three years earlier.

The $1.78 trillion is not what people owed; it is the amount of their total credit lines on plastic. Americans typically only draw down an average of 20–25% of their available credit card lines. The problem is that if an average consumer does get into financial trouble for any reason, he now has much greater ability to turn to his untapped credit card lines to forestall the day of reckoning. By the time he ends up in bankruptcy court, he can have massively larger unsecured debts than he could have had before, because credit card issuers have been making such large increases in available lines to try to keep their customers happy and avoid losing them to competitors.

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So in our opinion, credit card issuers are being unfairly treated by their critics in some regards, while on the other hand most of the critics haven't really noticed what the card issuers actually have done to exacerbate the cost of bankruptcy. We have advised credit card issuers in our research publications to stop using large credit lines as a marketing tactic.

THE INTANGIBLE ISSUES: HARD TO MEASURE, BUT THEY EXIST

The really interesting thing about all the problems I've just described is that they explain some of the bankruptcy mess, but not all of it.

Personal financial disasters and per capita debt-to-income ratios have worsened gradually. They did not get worse by 29% in 1996 over 1995, but bankruptcies did. They did not worsen again by 20% in 1997 over 1996, but bankruptcies did. So, the hunt for causes of bankruptcy isn't over yet.

The only available conclusion is that certain intangibles are playing a role. One is lawyer advertising. Like adjustable rate debt, you rarely saw any lawyer advertising for bankruptcy prior to about the mid-1980s. In fact, lawyers didn't advertise for much of anything.

Today, lawyer advertising for bankruptcy is prevalent and often provocative. We did a brief study of telephone book ads and found that cities with high bankruptcy filing rates usually do have higher levels of lawyer advertising than cities with low filings rates. A recent look through the Las Vegas Yellow Pages shows more than 100 pages of lawyer advertising, of which roughly one in 10 mentions or is devoted to bankruptcy. Las Vegas has one of the highest urban area bankruptcy rates. We're sure lawyers would argue that they are merely responding to higher demand of their services. But since the whole purpose of advertising in any business is to sell products and services, we would imagine that advertising for bankruptcy gets results, too, and helps convince at least some people to use bankruptcy to eliminate their debts. We have no idea how to measure this precisely.

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At the same time, we agree with Fed Chairman Greenspan, who has attributed the bankruptcy increase to a general loss of social stigma once attached to the subject.

We can see in our database a very interesting fact along these lines. Places that used to have very low bankruptcy rates back in 1989, when we started compiling the data, have had a mixed experience since then. Some have stayed low, and some have gotten a little worse, and some have gotten a lot worse. But when we look at places that had very high bankruptcy rates back in 1989, they've virtually all stayed high and never got better. Why would that be?

Certainly, one explanation must be that when bankruptcy filing becomes common in a local area, everyone ends up knowing someone who did it. Bankruptcy becomes de-mystified and begins to lose its embarrassment. Indeed, if you know a person who ended up prospering as a result of bankruptcy, then bankruptcy certainly may begin to sound like a smart strategy—like a mortgage refinance.

At the same time, consumers have watched the stigma of bankruptcy disappear in the business world. The airlines have filed for bankruptcy—some more than once—and yet the planes usually keep flying. Retailers have filed, yet the stores stay open. Bankruptcy thus must be something other than financial disaster.

IMPACT OF PERSONAL BANKRUPTCIES

What impact are bankruptcies having on consumers and on the nation's financial institutions? The short answer is that rising bankruptcies are impacting all consumers and some, but not all, lenders.

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Many large commercial banks have been reporting record or near-record profits. That is true in part because some banks do more commercial lending than consumer lending, and it's also true because financial institutions pass along the cost of bankruptcy in their rates and fees, as they do with other costs.

The same could be said of non-bank creditors. Any business is a creditor when it provides good or services and waits to be paid for them later on: electric and gas utilities, phone companies, landlords, retail stores with credit cards or other credit plans, doctors, dentists, hospitals, and others. All these businesses extend credit without collateral and lose what they are owed when unsecured debts are expunged in bankruptcy. So, the cost of bankruptcy is included on the expense side of the income statement. Banks put bankruptcy costs in their "provisions for loan losses;" AT&T includes its bankruptcy costs in a line on its income statement called "uncollectible bills." Consumers may or may not be aware of it, but most of what they spend every month has a bankruptcy cost factor built into it, from the phone bill to the car payment to the rent and the credit card bill.

Lenders' business can be divided into two basic parts: loans made to individuals and loans made to businesses. Recently, business lending has been very profitable. Loan demand has been strong thanks to the economy and credit quality has been excellent. Oddly enough at a time when consumer bankruptcies are skyrocketing, credit quality on commercial loans is the best we've seen in many years.

As recently as the late 1980s, commercial mortgage loans and loans on apartment buildings had very high delinquency and loss rates, due in part to sloppy lending and due in part to the fact that shopping centers, apartments, and office buildings were overbuilt in the 1980s. Today, when we aggregate the FDIC call and income reports of commercial banks—and even when we look at the quarterly financial reports of the nation's remaining thrifts—we see the opposite. Net chargeoffs are now extremely low on commercial mortgages and apartment building mortgages, as well as on non-real-estate commercial and industrial loans made to corporations for miscellaneous purposes. So, one reason behind good bank profits is the extraordinary strength of commercial lending.

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When we turn to loans made to individuals, we must subdivide that world into secured and unsecured loans. All of these are indeed being impacted by the personal bankruptcy increase, but the bulk of these loans are in 1–4 unit residential mortgages, which have homes as collateral. Lender losses on mortgages are comprised of chargeoffs when loans go into foreclosure minus recoveries when the foreclosed properties get sold. Here again, the strong economy and the super-powered housing market have helped enormously. In both 1996 and 1997, we saw record numbers of home purchases, plus accelerating average home prices. This has meant that foreclosed homes coming onto the market are selling rapidly and for good prices, enabling mortgage lenders to recover a substantial portion of their charged off loans.

Of course, if the housing market slows, as it eventually must, then we will see more damage to mortgage lenders from bankruptcies. I know that the Mortgage Bankers Association is worried about this.

Let's move to unsecured lenders. Here, we do see the impact of personal bankruptcies now. Each year, SMR produces a combined income statement for credit card banks, using the FDIC call reports and defining these banks as any banks whose credit card outstandings are more than 50% of their total loans. There are about 60 such banks in the United States, and they represent well over half of all credit card receivables.

From 1994 to 1996, these banks as a group saw their after-tax profits as a percent of average managed assets decline from 2.26% to 1.31%, and the principle reason was the increase in the provision for loan losses, in turn higher due to escalating bankruptcies. When we calculate profitability for card issuers in 1997, in about a month, we strongly believe we'll see the 1.31% margin fall further to just over 1% even. Some credit card banks already have been unable or unwilling to cope, hence we have seen such events as Advanta Corp. recently selling its ailing card business to Fleet, and AT&T selling its card business to Citicorp.

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Credit card profitability, although much reduced, is still OK for the time being. The reason for that is simple: credit card issuers have raised their prices to help compensate for bankruptcies. It's not the interest rates on credit cards that have gone up, but the fees.

About 10 years ago, in 1987 and 1988, our collection of credit card direct mail pieces shows that late payment fees most typically were $5 or $10. In 1996, card issuers really started raising these fees, and they now usually range from $15 to $25. Also back in 1987 and 1988, many issuers charged no fees at all when consumers exceeded their credit line limits, although some charged $5 or $10. Now, over-limit fees also have jumped to the $15 to $25 range.

The fastest-rising cost in credit cards is consumer bankruptcy, so these fee increases are being used to help pay for that cost and keep profits up. These new fees are arguably unfair, since they cannot be assessed on the bankruptcy filers who have caused them, and instead are charged to a class of people who can least afford to pay for them: people who have not filed for bankruptcy but are late payers or are over their credit limits, often due to financial stress. That's unfortunate, but how do you make a price increase fair when you cannot assess it on the customers who cause a cost increase?

We have tried to estimate the public cost of bankruptcy, although this is not easy to do. The right method would be to have someone follow through to fruition all bankruptcy cases and add up all the amounts of debt ultimately discharged. No one I know has the time or money to do this.

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So, we can only use available data to make rough estimates of the cost of bankruptcy. One method is to look at how many good-paying customers creditors need to offset the impact of a single bankruptcy.

For creditors, bankruptcy is a pre-tax expense. Our method is to look at the typical pre-tax profit earned by lenders per household and see how many households are needed to offset the cost of a bankruptcy filing.

As of June, 1997, total outstanding consumer debt was $7.2 trillion, including a pro-forma debt amount for renters. Total outstanding financial debt per U.S. household turns out to be $72,455. In 1996, the most recent full year available, all U.S. banks as a group earned pre-tax profits of 1.74% of their outstanding assets, therefore their earnings per household would be 1.74% of the $72,455, or $1,261.

The average amount discharged in a personal bankruptcy appears to be somewhere around $41,000, by our estimate from data compiled by Visa and the Credit Research Center. So, if you earn $1,261 from good-paying households per year, you divide that into the $41,000 you lose in a bankruptcy and conclude that it takes 33 good-paying households to pay for a single bankruptcy case.

In some ways, this impact is understated. In our compilation of debt, we did include a pro-forma amount for renters, but in fact the lenders don't get that money, landlords do. If you subtract the renter debt, you end out with total U.S. consumer debt of $5.139 trillion, or about $51,390 per U.S. household. Then, the lenders' pre-tax margin of 1.74% yields pre-tax income of $894 per household, and suddenly you find it takes 46 goodpaying households to make up for one bankruptcy.

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The following table shows the more conservative assumption and concludes this paper.

Table 2

Number of good-paying households it takes to pay for one personal bankruptcy case:

No. of households in the United States: 100 million.

Financial Debt/Household: $72,455.

All banks, pre-tax return on assets in 1996: 1.74%.

Financial industry pre-tax profits per household: ($72,455 × 1.74%): $1,261.

Average amount discharged in a personal bankruptcy: $41,000 (Staten & Visa data, from samplings).

Number of good, bill-paying households needed to compensate for one bankruptcy filer ($41,000/$1,261): 33.

Mr. **GEKAS.** Thank you.

Mr. **GEKAS.** Mr. Lauritano is next in the order that I read them.

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STATEMENT OF MARK LAURITANO, SENIOR VICE PRESIDENT, WEFA, INC

Mr. **LAURITANO.** Thank you. Good afternoon, Mr. Chairman and members of the subcommittee. My name is Mark Lauritano. I am a Senior Vice President with the WEFA Group. WEFA is an economic consulting firm that was founded by Lawrence Klein, Nobel Laureate from the University of Pennsylvania. WEFA serves over 1200 clients, both in government and the private sector on various economic topics.

I am pleased to appear today to discuss the results of an important new study that WEFA just released. The study calculates the financial cost to the U.S. economy of the current bankruptcy system and analyzes one legislative approach currently being considered by Congress.

To provide some historical context to this analysis, I've produced a chart which is on my left, the line graph, that shows the trend in personal bankruptcy filings in the United States since 1980.

As you can see, the line gets very steep over the past several years, years in which the U.S. economy in general has been performing quite well. In fact, personal bankruptcies have increased over 50 percent since 1994, and hit an all time high last year at over 1.3 million filings.

While the rise in personal bankruptcy filings has received considerable attention, little research has been conducted on the macro-economic costs of the system. Based on our analysis, we estimate that the financial costs of the personal bankruptcy system in 1997 was $44.3 billion.

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The costs related to personal bankruptcy involve both unsecured and secured credit losses, as well as system administrative expenses. Our methodology first estimated the dollars at risk in personal bankruptcy by reviewing a sample of 7,000 bankruptcy petitions.

We separately analyzed the likely repayment of the dollars at risk. The difference between these two amounts results in the credit losses related to personal bankruptcy. By also including administrative expenses such as court costs and legal fees, we derived the total impact on the economy.

Ultimately, these costs must be absorbed by the economy. How they are passed on to consumers can vary. If these costs are passed on in the form of higher prices, each American household would have to pay roughly $400 per year. To put it in slightly different terms, if these costs were passed through in the form of higher interest rates, it would translate into three additional percentage points consumers would pay for each unsecured loan.

We consider this a significant burden to the economy, and as a result, to consumers. And these amounts will continue to grow over time, and that is why it is urgent that Congress act now. Failure to act will place increased burdens on the majority of consumers that pay their bills.

As you can see from this next chart, the bar chart on my left, we project that the total cumulative cost to the American economy could amount to over $220 billion from 1997 to the year 2000. And this is a conservative estimate.

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For example, it is based on the assumption that the rate of personal bankruptcy growth slows to 15 percent per year going forward to the end of the decade, when the actual growth was over 20 percent per year over the last 2 years.

We have also done analysis on the needs-based formula highlighted in two legislative proposals in the House. The formula would require debtors with enough disposable income to repay a portion of their debts. These additional payments will reduce the cost to creditors, and given the highly competitive nature of this market, result in lower fees or interest rates to consumers.

We found that, if enacted, this formula could potentially save the U.S. economy between $14.5 billion and $29.5 billion over the next several years. This is a significant amount, and one that is clearly worthy of Congressional attention.

This concludes my prepared remarks, and I would be happy to answer any questions that the subcommittee might have regarding this research.

[The prepared statement of Mr. Lauritano follows:]

PREPARED STATEMENT OF MARK LAURITANO, SENIOR VICE PRESIDENT, WEFA, INC.

Good afternoon Mr. Chairman and members of the Subcommittee. My name is mark Lauritano and I am Senior Vice President with the WEFA Group. WEFA is an economic consulting firm that was founded by Lawrence Klein, Nobel Laureate from the University of Pennsylvania. WEFA serves over 1,200 clients both in government and the private sector on various economic topics. I am pleased to appear today to discuss the results of an important new study that WEFA has just released. The study calculates the financial costs to the U.S. economy of the current personal bankruptcy system and analyzes one legislative approach currently being considered by Congress.

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To provide some historical context to this analysis, I have produced a chart that shows the trend in personal bankruptcy filings in the United States since 1980. As you can see, the line gets very steep over the past several years, years in which the U.S. economy in general has been performing quite well. In fact, personal bankruptcies have increased over 50 percent since 1994 and hit an all time high last year at over 1.3 million filings.

While the rise in personal bankruptcy filings has received considerable attention, little research has been conducted on the macro-economic costs of the system. Based on our analysis, we estimate that the financial cost of the personal bankruptcy system in 1997 was $44.3 billion dollars.

The costs related to personal bankruptcy involve both unsecured and secured credit losses as well as system administrative expenses. Our methodology first estimated the dollars at risk in personal bankruptcy by reviewing a sample of 7,000 bankruptcy petitions. We separately analyzed the likely repayment of the dollars at risk. The difference between these two amounts results in the credit losses related to personal bankruptcy. By also including administrative expenses such as court costs and legal fees, we derived the total impact on the economy.

Ultimately, these costs must be absorbed by the economy. How they are passed on to consumers can vary. If these costs are passed on in the form of higher prices, each American household would have to pay roughly $400 per year. To put it in slightly different terms, if these costs were passed through in the form of higher interest rates, it would translate into 3 additional percentage points consumers would pay for each unsecured loan.

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We consider this a significant burden to the economy and, as a result, to consumers. And these amounts will continue to grow over time. As you can see from this next chart, which is also attached to my written statement, we project that the total cumulative cost to the American economy could amount to over $220 billion from 1997 to the year 2000. And this estimate is conservative. For example, it is based on the assumption that the rate of personal bankruptcy growth slows to 15 percent per year going forward to the end of the decade, when the actual growth was 20% per year over the last two years.

We have also done analysis on the needs-based formula highlighted in two legislative proposals in the House. The formula would require debtors with enough disposable income to repay a portion of their debts. We found that if enacted, this formula could potentially save the U.S. economy between $14.5 and $29.5 billion over the next several years. This is a significant amount and one that is clearly worthy of Congressional attention.

This concludes my prepared remarks and I would be happy to answer any questions that the Subcommittee might have regarding this research.

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Mr. **GEKAS.** We thank you very much. We turn to our next witness, Prof. Ausubel.

STATEMENT OF LAWRENCE M. AUSUBEL, PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND

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Prof. **AUSUBEL.** Mr. Chairman, and members of the subcommittee, I am honored by the invitation to appear before you today.

The number of personal bankruptcies now exceeds one million per year, reaching 1.35 million in 1997. What is responsible for the rise in bankruptcies? All available statistical evidence points to the record level of household debt as the immediate cause.

My first graph resembles that of the previous witness, but includes a missing line. The blue line plots personal bankruptcy filings, while the red line plots the ratio of household debt to disposable income. As you can see, they track each other quite closely.

In 1984, aggregate American household debt equalled 58.0 percent of aggregate American disposable personal income. By the third quarter of 1997, the household debt had mushroomed to 83.5 percent of disposable personal income. Changes in debt lead changes in bankruptcies by several quarters.

The obvious correlation is no statistical artifact. At the micro level, the amount of revolving credit outstanding is a strong predictor of whether a given individual will file for bankruptcy.

We now need to go back a step and examine what is responsible for the rise in debt. There are numerous factors behind the rise in household debt, but one of the most important factors is the high rate of profit associated with consumer credit and the corresponding incentives for aggressive lending.

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Since 1983, credit card lending has been one of the most profitable areas of banking. This has created strong incentives for credit card issuers to assertively expand the size of their portfolios and is reflected in extremely large volumes of direct mail, preapproved credit card solicitations.

As illustrated in my second graph, the volume of credit card solicitations was only 453 million in the second quarter of 1993, shortly before the recent run-up in debt and bankruptcies. During the ensuing 3 years, the volume of solicitations typically hovered around 700 million per quarter, and following a temporary dip in 1996–97, reached a record 881 million in the second quarter of 1997.

My earlier research has documented that credit card lending earned three to five times the ordinary rate of return from banking activities during the period 1983 to 1993. Evidence of continuing extra normal profits can be obtained from examining the stock market performance of the great monoline credit card issuers, First USA, MBNA and Capital One Financial.

The total return on shares of First USA from its initial public offering in May 1992 through its acquisition in the spring of 1997 equalled 2100 percent. By comparison, the total return on the S&P 500 equalled 132 percent during this same period. You heard correctly: during a period when the overall market slightly more than doubled, First USA increased by a factor of 20.

The total return on shares of MBNA, who you heard from earlier, from its initial public offering in January 1991 through the present, I calculate at 1800 percent. Capital One went up by a mere 330 percent.

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The typical credit card interest rate today is——

Mr. **DELAHUNT.** Could you say that number again?

Prof. **AUSUBEL.** Which one? Capital One went up by 330 percent during a period that the S&P 500 went up 142 percent. Mr. **NADLER.** MBNA?

Prof. **AUSUBEL.** 1800 percent, S&P went up 284 percent. The typical credit card interest rate today is 15.6 percent, while the cost of funds is only 6 percent. You can make money on credit cards, even if you lend to fairly risky customers. This helps explain the high default on credit cards today.

Some lender organizations have recently proposed broad restrictions on bankruptcy protection. Their proposal, self-styled as needs-based bankruptcy, has been incorporated into several bills recently introduced into the Congress, including H.R. 2500, H.R. 3150 and S. 1301.

These bills would have the effect of forcing many debtors who are currently eligible for chapter 7 bankruptcy filings into chapter 13. In my professional opinion, these bills are substantially misdirected, and if adopted, would likely lead to a generally worsened social outcome in two respects.

First, one of the traditional purposes of personal bankruptcy relief is to relieve the honest, but insolvent debtor of oppressive indebtedness and to permit a fresh start. The so-called needs-based bankruptcy is little more than a sharp retreat from the fresh start doctrine.

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My second objection is that by increasing the expected profitability of lending to marginal customers, these bills are likely to lead to the unintended consequence of still more lending to marginal customers and hence, an increase in the incidence of overextended consumers.

My prepared testimony runs through this argument in some detail, if I can just describe the basic outlines here. The lender proposals would restrict access to bankruptcy protection and so would increase the expected profitability of lending.

As a consequence, lenders will desire to lend even more. Lenders will increase the pace of solicitations and credit line expansions. That is, we should anticipate an outward shift in the supply curve. Meanwhile, we should anticipate only a minimal downward shift in the demand curve. Thus, in equilibrium, the proposals should result in further increases in outstanding debt.

Paradoxically, we conclude that the likely effect of limiting bankruptcy protection for unsecured debt is an increase in the outstanding balances of marginal consumers. In our efforts to curtail the incidence of delinquency and default, we only increase the frequency with which consumers are buried under mountains of debt.

H.R. 3146 proposes a very different approach to bankruptcy reform. The bill proposes to limit credit overextensions by restricting the claims of lenders who cause unsecured debts to exceed 40 percent of the debtor's annual income.

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This approach is to be commended, as it attempts to go beyond the symptom of consumer bankruptcy and to address one of the causes. At the same time, I would like to take this opportunity to urge that a more comprehensive solution could be attempted by instituting strict time priority on all credit card debt.

Generally speaking, under current law, if a consumer who files for bankruptcy has $20,000 in unsecured debt and only $10,000 available to repay it, all unsecured creditors will receive 50 cents on the dollar. It makes no difference that the first $10,000 in unsecured debt may have been a relatively prudent loan, but that the second $10,000 in debt may have been a deliberately risky proposition.

In other words, later lenders impose risk on earlier lenders since additional lending increases the probability that the original debt is defaulted upon. Yet the later lender has equal claim on assets. This is both unfair to cautious earlier lenders, as well as a prescription for credit overextension to occur.

By strict time priority, I just mean the establishment of a rule that under bankruptcy, available resources would go to fully repay earlier credit card lenders before later credit card lenders receive any repayment at all. In the example I was describing, the first $10,000 would get repaid in full, and the second $10,000 would get repaid not at all.

[The prepared statement of Prof. Ausubel follows:]

PREPARED STATEMENT OF LAWRENCE M. AUSUBEL, PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND

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BIOGRAPHICAL INFORMATION

Lawrence M. Ausubel is Professor of Economics at the University of Maryland at College Park. He received his A.B. from Princeton University in 1980 and his Ph.D. in economics from Stanford University in 1984. He is the author of "The Failure of Competition in the Credit Card Market" (*American Economic Review,* March 1991), which is generally considered the best-known article on credit cards in the economics literature. He has also written a 1995 working paper, "The Credit Card Market, Revisited," and the entry on "'Credit Cards" in the *New Palgrave Dictionary of Economics.* More recently, he has studied the recent upsurge in personal bankruptcies. He is the author of "Credit Card Defaults, Credit Card Profits, and Bankruptcy" (*American Bankruptcy Law Journal,* Spring 1997), which he wrote for presentation at the National Conference of Bankruptcy Judges. This article was recently awarded the Editor's Prize for the best article in the *American Bankruptcy Law Journal* in 1997. He has testified on this subject before the U.S. Senate Subcommittee on Financial Institutions and Regulatory Relief in February 1998, and before the National Bankruptcy Review Commission in January 1997.

DISCLOSURE OF FEDERAL GRANTS, CONTRACTS, OR SUBCONTRACTS

Professor Ausubel was the principal investigator on National Science Foundation Grant SBR–94–10545 to the University of Maryland, October 15, 1994–September 30, 1997, for $167,737. The grant, entitled "Bargaining Power, Sequential Recontracting, and the Principal-Agent Problem," pertains to bargaining theory. He is also the principal investigator or co-principal investigator on two pending National Science Foundation grants on auction theory, which he has been verbally told will be awarded in the current fiscal year (but have not yet been awarded). The subject matter of these grants bears no relation to the topic of the current hearing.

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EXECUTIVE SUMMARY

1. All available statistical evidence points to the record level of household debt as the immediate cause of the record number of personal bankruptcies. In turn, there are numerous factors behind the rise of household debt, but one of the most important is the high rate of profit associated with consumer credit and the corresponding incentives for aggressive lending.

2. Some lender organizations have recently proposed a broad restriction on access to bankruptcy protection, self-styled as "needs-based bankruptcy," which has been incorporated into several bills recently introduced into Congress, including H.R. 2500, H.R. 3150, and S. 1301. These bills are substantially misdirected and, if adopted, would likely lead to a generally-worsened social outcome in two respects. First, these bills represent a substantial retreat from the traditional bankruptcy objective of allowing the debtor a "fresh start," and as such, are subject to the economic arguments underpinning the fresh start doctrine. Second, to the extent that these bills would increase the expected profitability of lending to marginal customers, they would lead to more lending to such customers and hence to an increase—rather than a decrease—in the incidence of overextended consumers.

3. It seems preferable to follow the general approach of H.R. 3146, which attempts to limit credit overextensions by restricting the claims of lenders who cause unsecured debts to exceed 40 percent of the debtor's annual income. At the same time, a more comprehensive solution could be attempted by instituting "strict time priority" on unsecured debts. Under current law, later lenders impose risk on earlier lenders, since additional lending increases the probability that the original debt is defaulted upon. Strict time priority would establish a rule that, under bankruptcy, available resources would go to fully repay earlier (unsecured) lenders before later (unsecured) lenders receive any repayment at all. Thus, creditors would be given every incentive to be more cautious about lending the additional balances which might push consumers over the edge into bankruptcy.

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4. Most of the consulting reports which purport to demonstrate the benefits of the lender bankruptcy bills make two basic errors, which render their conclusions almost irrelevant to the current policy debate. First, the consulting reports assume that lender behavior will remain unchanged in a world where bankruptcy protection is limited, leading to the questionable conclusion that the bills will reduce the costs of bankruptcy. They ignore that lenders are likely to offset the tightened bankruptcy access with still more aggressive lending. Second, the consulting reports assume that the savings from restricted bankruptcy protection will get passed along, on a one-to-one basis, to consumers. They forget that all empirical evidence on the credit card market has been that most cost savings are kept by lenders, rather than getting passed through to consumers. The most likely effect of restricting bankruptcy protection is merely a windfall gain in profits for lenders, and little or no benefit to consumers.

PREPARED TESTIMONY

Mr. Chairman and members of the Subcommittee, I am honored by the invitation to appear before you today. This hearing, I understand, is concerned with the record level of personal bankruptcies, its causes, its costs, and proposed legislative solutions. I hope that my input is helpful to your discussions of bankruptcy reform.

1. Personal Bankruptcies and the Household Debt Burden

The number of personal bankruptcies exceeded one million for the first time in 1996, and reached more than 1.3 million in 1997. What is responsible for the record level of bankruptcies? All available statistical evidence points to the record level of household debt as the immediate cause. At the macro level, the ratio of household debt to disposable personal income correlates closely with the rate of personal bankruptcies. At the micro level, the amount of revolving credit outstanding is a strong predictor of whether a given individual will file for bankruptcy.

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Figure 1 illustrates the time trend of personal bankruptcies and the household debt burden. In 1984, aggregate American household debt (consumer credit outstanding + mortgage debt) equaled 58.0% of aggregate American disposable personal income. By the third quarter of 1997, the household debt had mushroomed to 83.5% of disposable personal income. Along the way, changes in the rate of personal bankruptcy filings fairly closely tracked changes in the household debt burden, with changes in the debt burden leading changes in bankruptcy filings by several quarters.

Happily, the statistical relationship between the household debt burden and personal bankruptcies suggests that the growth in bankruptcy filings should markedly slow in 1998. The ratio of debt to disposable income increased at roughly only half the rate in 1997 that it did in the preceding three years. This leads to the prediction that bankruptcy filings should rise at a markedly slower rate in 1998 than they did in 1995, 1996 and 1997. At the same time, we should not become overly sanguine about the expected plateau in 1998; it is clear from historical experience that when we enter the inevitable next economic recession, consumer defaults and personal bankruptcies are likely to reach new record levels.

A. The Rise in the Household Debt Burden

If the long-term rise in the bankruptcy rate is caused by the rise in household debts, we now need to go back a step and examine what is responsible for the rise in the household debt burden. Consumer advocates would have us believe that the rise in the debt burden is importantly due to the increasingly-aggressive marketing efforts of lenders. The credit industry has replied that the long-term rise in housing prices has importantly contributed to a long-term rise in mortgage debt, which is the largest component of household debt. In my professional opinion, both of these claims are correct.

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My own research has found that, since 1983, credit card lending has been one of the most profitable areas of banking. This has created strong incentives for credit card issuers to assertively expand the sizes of their portfolios, and is reflected in extremely large volumes of direct-mailed preapproved credit card solicitations. As illustrated in Figure 2, the volume of credit card solicitations was "only" 453 million in the second quarter of 1993, shortly before the recent run-up in debt and bankruptcies. During the ensuing three years, the volume of solicitations typically hovered around 700 million per quarter and, following a temporary dip in late 1996–early 1997, reached a record 881 million in the second quarter of 1997. It is useful to recognize that the figure of 881 million solicitations in a quarter translates to an average of about 9 direct-mailed solicitations in a 13-week period per American household—creditworthy or not.

At the same time, it would seem like a case of statistical overkill to say any more than a few words about the long-term rise in American housing prices and its obvious contribution to the rise in mortgage debt. In particular, this is surely a significant contributor to the rise in the ratio of household debts to disposable personal income in the 1980's—although it is not necessarily an important factor in the 1990's, when the housing market has been closer to flat.

B. A Few Comments on Statistical Issues

Before proceeding ahead with an analysis of the lender proposals for bankruptcy reform, it is worth clarifying a few statistical issues concerning the link between bankruptcy filings and the household debt burden. First, a recent report by MasterCard International maintains that the aforementioned ratio of household debt to disposable personal income now overstates the debt burden of the household sector, as credit cards are being substituted for cash and checks as a method of payment. However, the numbers which are displayed in Figure 1 specifically exclude convenience use of credit cards (including only the portion of revolving credit which is rolled over from month to month), yet they still display the well-known sharp increase. Moreover, it may be argued that other components of the standard consumer credit data now understate the debt burden of the household sector, as there has been a fair amount of substitution from auto loans (which are included as consumer credit) to auto leases (which apparently do not show up on the household balance sheet).

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Second, although a substantial part of the run-up in mortgage debt merely reflects an increase in housing prices, it would be incorrect to exclude mortgages from our debt burden calculations. This is because there has also been a fair amount of substitution from credit card loans (which are included as consumer credit) to home equity loans (which are a component of mortgage debt); excluding mortgage debt thus might substantially understate the growth of household borrowing in the 1990's.

Third, the credit industry has emphasized the role of such other factors as medical emergencies, marital breakups, gambling, and reduced stigma associated with bankruptcy in the recent record levels of bankruptcy. While each of these other factors undoubtedly plays some role here, I am not aware of any convincing statistical evidence that these factors are especially important.

Finally, in my opinion, the statistical view which I am presenting here is as close as we have to a consensus view today. For example, it accords generally with the testimony of Kim J. Kowalewski, Chief of Financial and General Macroeconomic Analysis at the Congressional Budget Office, before the National Bankruptcy Review Commission in January 1997. Kowalewski also emphasized that there has been a fairly close correlation between the household debt burden and personal bankruptcy filings over a 35-year period. It also accords generally with a recent study by Paul Paquin and Melissa Squire Weiss of Capital One Financial Corporation (one of the largest issuers of MasterCard and Visa cards in the United States). Paquin and Weiss conclude that 98% of the variation in the personal bankruptcy rate during 1987–96 can be explained by four factors: the growth in the number of bankcard accounts; the household debt-to-income ratio; initial unemployment claims; and the one-year Treasury bill rate.

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2. Economic Analysis of Lender Bankruptcy Bills

A. Retreat from a Fresh Start

Some lender organizations have recently proposed broad restrictions on bankruptcy protection. Their proposal, self-styled as "needs-based bankruptcy," has been incorporated into several bills recently introduced into Congress, including H.R. 2500, H.R. 3150, and S. 1301. These bills would have the effect of forcing many debtors, who are currently eligible for Chapter 7 bankruptcy filings, into Chapter 13 filings. In my professional opinion, these bills are substantially misdirected and, if adopted, would likely lead to a generally-worsened social outcome in two respects. First, these bills represent a substantial retreat from the traditional bankruptcy objective of allowing the debtor a "fresh start," and as such, are subject to the economic arguments underpinning the fresh start doctrine. Second, to the extent that these bills would increase the expected profitability of lending to marginal customers, they would lead to more lending to such customers and hence to an increase—rather than a decrease—in the incidence of overextended consumers. This section of my testimony will focus on the fresh start issue and the next section will focus on the unintended consequence of greater debt.

One of the traditional purposes of personal bankruptcy relief is to relieve the honest but insolvent debtor of oppressive indebtedness and to permit a "fresh start." The economic argument for allowing a "fresh start" is precisely the same as the economic argument for reducing marginal income tax rates. Congress has favored low marginal tax rates in the 1980's and 1990's on account that high marginal tax rates create disincentives for productive activity. This argument states that any individual who faces a high marginal tax rate is provided with bad incentives in the labor-leisure choice: if the government is going to take a high fraction of the individual's wages as taxes, then it may not make sense for the individual to work hard and earn high wages. Moreover, to the extent that the marginal tax rate becomes punitively large, the individual is given strong incentives to go "off the books" completely, working for cash in the underground economy.

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Precisely the same logic applies to the overextended debtor. The required repayment rate to creditors takes exactly the same role as a high marginal tax rate. Suppose that debts get so out of hand that essentially all of an individual's earnings, above subsistence and taxes, must go toward the repayment of creditors. Then it may not make sense for the individual to work hard and earn high wages, and the individual may be tempted to go off the books completely, working for cash in the underground economy. Chapter 7 bankruptcy is the escape hatch which provides the overextended debtor an opportunity to have a fresh start, with restored incentives for hard work and participation in the mainstream economy.

The so-called needs-based bankruptcy is little more than a sharp retreat from the fresh start doctrine. As I understand H.R. 3150, the insolvent individual who is forced into a Chapter 13 repayment plan may find himself facing income taxes and repayment requirements totalling close to 100% of his marginal income, for up to a five-year period. The disincentives for hard work, and the incentives to go off the books, may become paralyzingly large. Given the close similarity between the low-tax-rate and fresh-start arguments, it would seem particularly unfortunate for Congress to enact such a high "effective tax rate" for the members of society whose balance sheets are the most strained, so soon after reducing (capital gains) tax rates for the members of society whose balance sheets are the most flush with assets.

Finally, observe that this economic argument for the fresh start doctrine only argues that debts should be wiped clean; it does not in any sense support the notion that individuals should be able to protect substantial amounts of assets under bankruptcy. Thus, I would strongly support the various proposals for limiting the homestead exemption, and for preventing individuals from shifting their assets into protected categories in advance of filing for bankruptcy.

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B. Unintended Consequences of the Lender Bankruptcy Bills

The basic explanation behind today's omnipresent credit-card marketing and high credit-card default rates is the high rate of profitability on lending: the typical credit card interest rate today is 15.6%, according to Federal Reserve statistics; meanwhile, the cost of funds is but 6.0%. In an environment in which the spread between revenues and costs is so large as to yield extranormal profits, each firm has the incentive to invest extraordinary resources toward obtaining new customers. In the case of the credit card market, an issuer can easily justify large marketing expenditures and tolerate a large amount of default risk in its customer base.

Since 1983, credit card lending has been one of the most profitable areas of banking. My earlier research documented that credit card lending earned three to five times the ordinary rate of return from banking activities, during the period 1983–93. The profitability of credit card lending and other banking activities are compared in Figure 3. While direct data concerning the profitability during the post-1993 period is unavailable, strong indirect evidence of continuing extranormal profits can be obtained from examining the stock market performance of the great monoline credit card issuers—First USA Incorporated, the MBNA Corporation, and Capital One Financial Corporation. The total return on shares of First USA, from its initial public offering in May 1992 through its acquisition by Banc One in the Spring of 1997, equaled 2,100 percent; by comparison, the total return on the S&P 500 equaled 132 percent during this same period. The total return on shares of MBNA, from its initial public offering in January 1991 through the present, equaled 1,800 percent; by comparison, the total return on the S&P 500 equaled 284 percent. The total return on shares of Capital One, from its initial public offering in November 1994 through the present, equaled 330 percent; by comparison, the total return on the S&P 500 equaled 142 percent. All of these calculations assume that dividends were reinvested.

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The lender proposals for so-called "needs-based bankruptcy" can be typified as a restriction on bankruptcy protection for credit card debt and other unsecured lending. All else being equal, these proposals would increase the expected profitability of lending to marginal customers. As such, they would lead to the unintended consequence of still more lending to marginal customers and hence to an increase—rather than a decrease—in the incidence of overextended consumers.

Let us see, in some detail, how this unintended consequence plays out. In Figure 4, we begin with a supply curve (denoted S) and a demand curve (denoted D) for unsecured credit. What is the likely effect of the proposed limitations on bankruptcy protection, on the supply curve? Lenders should be expected to rationally recognize that their probability of loss has been reduced by the change in law and, thus, they should be willing to lend increased quantities of unsecured debt at any given price (e.g., interest rate). Thus, we should anticipate an outward shift in the supply curve, from S to S, in Figure 4.

What is the likely effect of the proposed limitations on bankruptcy protection, on the demand curve? Consumers should be expected to exhibit very little change in their borrowing behavior, for at least two reasons. First, unlike lenders, many consumers will fail to learn (at the time they are borrowing) about fairly technical changes in the bankruptcy law. Second, even to the extent that consumers do learn of the change in the law, experience strongly suggests that consumers will fail to act on the information. Just as many consumers may systematically underestimate the extent of their current and future credit card borrowing, it should be expected that many consumers may systematically underestimate (at the time they borrow) the probability with which they will eventually fall into bankruptcy. Many or most consumers will underestimate the likelihood that they will become insolvent, and hence they will underreact to the reduction in bankruptcy protection. Thus, we should anticipate only a minimal shift in the demand curve, from D to D, in Figure 4.

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Let us now see the likely effects of the proposed limitations on bankruptcy protection in the market for unsecured credit to marginal customers. The original equilibrium (i.e., the intersection point of S and D) corresponds to a price of *p* and a quantity of *q* in Figure 4. As we have seen above, the supply shift (i.e., the increase in the willingness of lenders to issue credit to marginal customers at a given price) may be substantial. The corresponding demand shift (i.e., the corresponding decrease in the willingness of marginal customers to accept credit at a given price) is fairly negligible and fails to offset the supply shift. Thus, the new equilibrium (i.e., the intersection of S and D) is associated with a somewhat lower price, *p*, than the original equilibrium. However, due to the greater magnitude of the supply shift than the demand shift, the new equilibrium is also associated with a higher quantity, *q*, of unsecured credit than the original equilibrium.

As depicted in Figure 4, it should be anticipated that the quantity effect will be more substantial than the price effect. The intuition for this prediction is that lenders will act on the change in bankruptcy law, whereas consumers will substantially fail to act. As a result, lenders will increase the pace of solicitations and credit line expansions, while marginal consumers should not be expected to neutralize this effect by declining the lenders' offers.

Paradoxically, we conclude that the likely effect of limiting bankruptcy protection for unsecured debt is an *increase* in the outstanding balances of marginal consumers. In our efforts to curtail the incidence of delinquency and default, we only *increase* the frequency with which consumers are buried under mountains of debt.

3. Strict Time Priority on Unsecured Debt

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H.R. 3146 proposes a very different approach to bankruptcy reform. The bill proposes to limit credit overextensions by restricting the claims of lenders who cause unsecured debts to exceed 40 percent of the debtor's annual income. This approach is to be commended, as it attempts to go beyond the symptom of consumer bankruptcy, and to address one of the causes.

At the same time, I would like to take this opportunity to urge that a more comprehensive solution could be attempted by instituting "strict time priority" on unsecured debts. Generally speaking, under current law, if a consumer who files for bankruptcy has $20,000 in unsecured debt and only $10,000 available to repay it, all unsecured creditors will receive 50 cents on the dollar. It makes no difference that the first $10,000 in unsecured debt may have been a relatively prudent loan but that the second $10,000 in debt may have been a deliberately risky proposition. In other words, later lenders impose risk on earlier lenders, since additional lending increases the probability that the original debt is defaulted upon, yet the later lender has equal claim on assets as the earlier lender. This is both unfair to cautious earlier lenders, as well as a prescription for credit overextension to occur.

By strict time priority, I mean the establishment of a rule that, under bankruptcy, available resources would go to fully repay earlier (unsecured) lenders before later (unsecured) lenders receive any repayment at all. In the previous example, the creditor who advanced the first $10,000 would be repaid in full, while the creditor who extended the second $10,000 would receive nothing. Thus, creditors would be given every incentive to be more cautious about lending the additional balances which might push consumers over the edge into bankruptcy.

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Observe that, under H.R. 3146, if the debtor in this example has an annual income of $50,000 or more, the 40% threshold is not crossed, and so the incentive problem of lenders is not addressed. Full time priority would solve this incentive problem.

Institution of strict time priority for unsecured debt is a reform on which, I believe, all sides of the bankruptcy debate might agree. As already stated, the proposed rule of H.R. 3146 is essentially a special case of time priority. Consumer representatives are likely to agree that most debtors who file for bankruptcy are unfortunates who became overextended on credit, and time priority would give lenders greater incentive to limit overextensions. At the same time, the lending industry is likely to agree that risky lenders may be harmful to prudent lenders, and time priority would help to remedy the incentive problem.

4. Comments on the Consulting Reports

The recent discussion of the lender bankruptcy bills has spawned a cottage industry of consulting reports, paid for by the credit industry, and purporting to demonstrate the benefits of the bankruptcy bills. Most of these consulting reports make two basic errors, which render their conclusions almost irrelevant to the current policy debate. First, the consulting reports assume that lender behavior will remain unchanged in a world where bankruptcy protection is limited, leading to the questionable conclusion that the bills will reduce the costs of bankruptcy. However, as we have seen in the previous discussion, tightened bankruptcy access is likely to lead to the unintended consequence that lenders will make more loans to already-overextended consumers. Thus, increased lending is likely to substantially offset any improved ability of lenders to collect. As a consequence, there is no reason to expect the reductions in bankruptcy costs which the consultants forecast.

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Second, the consulting reports assume that any savings from restricted bankruptcy protection will get passed along, on a one-to-one basis, to consumers. However, if you examine the credit card market from the early 1980's through the early 1990's, you find that the cost of funds dropped by 7 to 10 percentage points, while the interest rates charged consumers dropped only a small fraction of that. You also find that during the past few years, the cost of bankruptcies to credit card issuers has substantially increased while the interest rates charged consumers have increased barely, if at all. There is no empirical basis for arguing that a reduction in bankruptcy losses will get passed through to consumers. The most likely effect is merely a windfall gain in profits for lenders, and little or no benefit to consumers.

5. Conclusion

Consumer delinquencies and personal bankruptcies moved in tandem and both have repeatedly attained record levels in recent years. Their movement together has led some to attribute the increases in consumer defaults to a perceived leniency in the current bankruptcy law and to advocate restrictions in bankruptcy protection. However, this view appears to confuse the direction of causation and more importantly to misperceive the social problem at hand.

The social problem is not so much the rise in personal bankruptcies as the rise in overextended consumers. Many recent proposals to restrict bankruptcy protection overlook this simple fact and naively equate restrictions on bankruptcy with social improvement. In particular, the so-called "needs-based bankruptcy" proposal represents a sharp retreat from the notion of a "fresh start" under bankruptcy, and would likely lead to severe incentive problems much akin to those created by an extremely-high marginal tax rate. Moreover, the new restrictions on bankruptcy protection would likely yield unintended consequences, probably only worsening the problem of consumer overextension.

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Some simple bankruptcy reforms would clearly be beneficial, such as overhauling the system of exemptions which enables some individuals to abusively shelter their assets while having their debts discharged. In addition, I have argued that establishing strict time priority on unsecured debts would help to align lender incentives with society's interests. Bankruptcy reform should be directed toward discouraging overextension from occurring in the first place, while preserving the availability of bankruptcy protection and a fresh start in the event that such overextension occurs and becomes overwhelming.

INSERT OFFSET RING FOLIOS 33 TO 36 **HERE**

Mr. **GEKAS.** Your written statement includes more examples, is that correct? Thank you. Mr. McKinley.

Ms. **JACKSON LEE.** Mr. Chairman, I am having to leave to chair another hearing, and I would appreciate if I could submit my questions in writing.

Mr. **GEKAS.** Without objection.

Ms. **JACKSON LEE.** Thank you very much.

Mr. **GEKAS.** Mr. McKinley.

STATEMENT OF VERN MCKINLEY, ESQ., REGULAR POLICY CONTRIBUTOR TO THE CATO INSTITUTE

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Mr. **MCKINLEY.** Thank you, Mr. Chairman, for the opportunity to testify on the issue of consumer bankruptcy and the credit industry. Pardon me for not bringing a big color chart. I'm an attorney, I've worked as a financial analyst for a number of Federal banking agencies, and I write regularly for the Cato Institute. I'm testifying today in my individual capacity.

The Constitution grants Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States." This power was intended to facilitate the collection of debts in interstate commerce. Unfortunately, bankruptcy law has evolved from a means to facilitate collection of debts to a means to facilitate evasion of debts.

The pronounced rise in consumer filings over the past 20 years is well-documented. I believe this increase is primarily due to the extraordinary benefits available from filing, the foremost of which is the discharge of debts.

The role that attorneys play in this increase is self-perpetuating and biased toward higher and higher filings. Furthermore, attorneys and their subordinates largely hold a monopoly position regarding the provision of bankruptcy services.

As attorneys are drawn into the practice of bankruptcy, the search for potential clients who may benefit from filing intensifies. This search for potential filers apparently hasn't reached the point of saturation. Although about one percent of households currently file, Michelle White of the University of Michigan argues that at least 15 percent of households would benefit financially by filing for personal bankruptcy.

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When borrowers get discharged from debts that they have the ability to repay, the costs are externalized to others, even to parties who were not part of the original credit transaction. This is a direct cost of maintaining the current bankruptcy system. The cost is distributed among creditors, good-credit-risk debtors and poor-credit-risk debtors.

A less obvious cost of the current bankruptcy system is that lenders, in reaction to borrowers' increased willingness to file, have tightened their lending standards, especially related to credit cards. As a result, marginal debtors, some of whom would more easily secure credit in a system without quick and easy bankruptcy, are being denied credit.

To restore the bankruptcy system to its constitutional purpose of facilitating the collection of debts, all consumer debtors should commit to a plan where a share of future income and a share of current assets are committed to repaying creditors.

If the debtor expects no income over the plan period, and has no assets to liquidate, then and only then should an immediate discharge be granted. Even under these stricter limits, discharge should be limited to once in a lifetime. Because bankruptcy would become an exercise in financial planning, non-attorney providers, such as accountants and financial planners should be allowed to prepare bankruptcy plans.

I would ask that my testimony and attachments be placed in the record, and thank you for the opportunity to appear before you. I will be pleased to answer any questions. I also invite you to the Cato Institute next Monday. We'll be having a policy forum and continue the debate on consumer bankruptcy issues. Thank you.

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[The prepared statement of Mr. McKinley follows:]

PREPARED STATEMENT OF VERN MCKINLEY, ESQ., REGULAR POLICY CONTRIBUTOR TO THE CATO INSTITUTE

Thank you for the opportunity to testify on the issue of consumer bankruptcy and the credit industry. My name is Vern McKinley and I work as an attorney for a federal financial regulatory agency. I also write regularly for the CATO Institute on financial and regulatory issues.

My first experience with the federal bankruptcy system was during the mid-1980s. I examined banks for the Federal Deposit Insurance Corporation in Texas during the banking crisis of that period. A review of the loan portfolio was a vital part of each examination and it was not uncommon for an examination team to review a number of loan files of borrowers who had filed for bankruptcy. My experience with bank credit issues was also developed working on the research staff of the Board of Governors of the Federal Reserve and as a financial analyst for the Resolution Trust

Corporation. Prior to my current position, I worked as an attorney in private practice and had the opportunity to work pro bono for an indigent borrower facing financial difficulties.. Finally, I have spent much of the past year researching the issue of consumer bankruptcy and the dramatic rise in the number of consumer filings. The final product of that research is an article published in the current issue of CATO Institute's quarterly magazine, *Regulation.* This article is attached as an appendix to my testimony along with a companion article by Joseph Pomykala which appears in the same issue. My remarks today are largely based on my article that appears in *Regulation.*

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Background.—The Constitution grants Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States." Like the Commerce Clause, this power was intended to facilitate the free flow of interstate commerce, as summarized in *The Federalist* No. 42:

The powers included in the THIRD class are those which provide for the harmony and proper intercourse among the States . . . to wit: to regulate commerce among the several States and the Indian tribes; to coin money, regulate the value thereof, and of foreign coin; . . . to establish a uniform rule of naturalization, and uniform laws of bankruptcy . . . The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question.

Bankruptcy law has evolved from a means to facilitate collection of debts to a means to facilitate evasion of debts, as it provides an attractive opportunity for consumer filers to cleanse themselves of debt. The pronounced rise in consumer filings over the past twenty years is well-documented. I believe this increase is primarily due to the extraordinary benefits available from filing, the foremost of which is a discharge of debts. The following issues have been the primary focus of attention of those attempting to explain this rise.

Economic cycle/joblessness.—If bankruptcy were truly a system that focused its relief on those suffering from economic dislocation, as some argue, then one would expect that when economic times are bad, filings would rise and when economic times are good, filings would fall. In fact, the opposite has been true over the last 20 years since the last major overhaul of the bankruptcy laws. Over this period there have been two lengthy economic recoveries. During both of these recoveries, four to five years into the business cycle, filings increased dramatically, ultimately to record levels. This is the phenomenon we are seeing today as during relatively good economic times with the unemployment rate below 5%, we have a record number of filings year-after-year. This pattern also occurred during the late 1980s, as filings reached record levels year-after-year, even as the unemployment rate drifted downward to slightly over 5%.

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Medical Bills and Divorce.—One major reason cited by filers for filing bankruptcy is large medical bills. Since such a large portion of medical bills is paid by third party providers, health care consumers have little incentive to contain health care costs, leading to enormous debts for the uninsured or underinsured. Fixing the system is important, but is independent from the analysis of bankruptcy. Many filers also blame divorce for their decision to file, but it is likely not the cause of the recent surge in filings since the early 1980s. Although the divorce rate rose steadily throughout the 1960s and 1970s, it has flattened throughout the 1980s and 1990s.

Easy access to debt, especially credit cards.—A recent report by the Consumer Federation of America places the blame for the recent increase in bankruptcies on "aggressive credit card marketing by issuers, chiefly banks, who have increasingly been targeting low and moderate income households." The Consumer Federation's solution to the rise in bankruptcies is to impose a limit on the availability of consumer credit, through legislative means if necessary.

Of course, being in debt is a necessary condition for filing bankruptcy. But, placing the blame for the increase in consumer bankruptcy filings on non-mortgage debt, as many self-appointed consumer groups have done, may be misguided. Consumer credit debt service burdens, what one researcher calls "a truer measure of the ongoing financial obligations that households face [than the debt-to-income ratio]," are at roughly the same level as they were 30 years ago (Paul C. Bishop, Federal Deposit Insurance Corporation, "A Time Series Model of the U.S. Personal Bankruptcy Rate." C. Alan Garner, Federal Reserve Bank of Kansas City; "Can Measures of the Consumer Debt Burden Reliably Predict An Economic Slowdown?"). On the other hand, mortgage debt service burdens have trended upward over this same period. In a number of ways, from the mortgage interest deduction to the creation of mortgage-related government sponsored enterprises, to the programs of the Federal Housing Administration, the Congress has strongly encouraged consumers to take on this mortgage debt. This encouragement of mortgage debt has been with the support of many of the same groups that have encouraged a tightening of non-mortgage debt.

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The recent expansion of non-mortgage credit availability to lower-income households is actually a positive development. It is especially encouraging because it has been accomplished without the heavy-handed federal incentives that have accompanied increases in mortgage debt. Any legislative effort to restrict consumer access to non-mortgage credit would have the government dictate to consumers and creditors how to make credit decisions. This would be a dangerous step toward a system of government credit allocation. Restrictions on debt tend to have the greatest adverse impact on marginal credit risks.

Reduced Social Stigma.—It is difficult to measure this decreased stigma, but one indicator is the sheer number of people filing, as there have been ten million filings over the past twenty years. Other indicators of a reduced stigma are the fact that surveys show roughly half of filers learn of the bankruptcy option from friends or family and the willingness of consumers to file bankruptcy more than once. The ease of filing clearly plays a role in both of these indicators.

The Lawyer's Role.—Coinciding with the recent increase in bankruptcy rates was a 1977 Supreme Court case that protected advertising by attorneys as commercial speech under the First Amendment. Prior to that time, many states forbade most types of lawyer advertising. Television expenditures for legal advertising over the twenty year period since that ruling have increased dramatically from a few million dollars per year to approximately $100 million per year (Diane Ellis, Federal Deposit Insurance Corporation—"The Influence of Legal Factors on Personal Bankruptcy Filings").

The role that attorneys play in the increase in filings is self-perpetuating and biased toward an ever-increasing level of filings. Furthermore, attorneys and their subordinates essentially hold a monopoly position regarding the provision of bankruptcy services and can utilize unauthorized practice of law statutes to maintain this monopoly position. Existing financial incentives encourage a high-volume, full-time bankruptcy practice, what some call a "very routinized practice." As the number of attorneys practicing in this area has increased, it has drawn others to the practice. As additional attorneys are drawn into the practice of bankruptcy, the search for consumers who may benefit from filing intensifies. This search for potential filers has apparently not reached a point of saturation. Although about one percent of households currently file, one researcher argues that at least 15% of U.S. households would benefit financially by filing for personal bankruptcy (Michelle J. White, University of Michigan—"Why Don't More Households File for Bankruptcy?").

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Changes in Demographics.—There is also evidence that the aging of the baby boom generation has contributed to the recent increase in bankruptcy filings. The prime years for bankruptcy filing are the peak borrowing years of age 24 to 54. The percentage of the American population in this category has increased from 34 percent to 44 percent over the last thirty years.

Changes in Legislation.—The Bankruptcy Reform Act of 1978 ("1978 Act") moved the bankruptcy laws in a pro-filer direction. As discussed in the attached article by Joseph Pomykala, the 1978 Act is simply part of a historical evolution that has been characterized by a continued ratcheting up of the attractiveness of filing in the form of expanded eligibility, property retainage and access to discharge. The impact of the 1978 Act, combined with the previously-discussed impact of expanded attorney advertising, has had startling results. For the twenty years prior to the implementation of the 1978 Act, bankruptcies trended upward from roughly 100,000 filings per year to 200,000 filings per year, a yearly rate of increase of less than five percent per year. Also during that twenty year period, each time filings increased by more than 15 percent in a year it was during an economic recession. For the nearly twenty years since the 1978 Act went into effect, bankruptcies trended dramatically upward from 200,000 filings per year to 1.35 million filings in 1997, a 12 percent rate of increase. During this time, as noted previously, many of the largest year-to-year increases in filings have occurred in the midst of strong economic recoveries.

Who Pays the Price for Bankruptcy?—To the extent that borrowers are getting debts discharged that they have the ability to repay, they are externalizing their debt problems, even to parties who were not part of the original credit transaction. This is a direct cost of maintaining the current bankruptcy system. Although the precise allocation of costs between these parties is uncertain, it is likely that these costs are absorbed by:

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(1) *Creditors*—because of the imprecision of the borrower screening process, creditors may not always be able to pass these costs on to debtors in the form of higher fees or interest rates.

(2) *Bad debtors*—as information and modeling of the credit allocation process becomes more sophisticated, creditors will more effectively be able to screen borrowers, identify potential filers, and potentially passing on some of the costs of bankruptcy to debtors who are most likely to file.

(3) *Good debtors*—because the credit screening process is not now, nor will it ever be perfect, some of the costs of bankruptcy may be passed on to good debtors in the form of higher rates and fees. However, because the competition for very strong debtors is intense and some of these debtors are easily identifiable, it is unlikely that these very strong debtors absorb much of the costs of bankruptcy.

A less obvious cost of the current bankruptcy system is that lenders, in reaction to borrowers' increased willingness to file, have tightened their lending standards, especially related to credit cards. This tightening was pronounced in early 1997 (Federal Reserve Senior Loan Officer Opinion Surveys—January, May 1997). As a result, marginal debtors, some of whom would more easily secure credit in a system without quick and easy bankruptcy, are being denied credit.

The Right Course.—To restore the bankruptcy system to its Constitutional purpose of facilitating the collection of debts in interstate commerce, all consumer debtors should commit to a plan where a share of future income and a share of current assets are committed to repaying creditors. If the debtor expects no income over the plan period, and has no assets to liquidate, then, and only then, should an immediate discharge be granted. Even under these stricter limits, discharge should be limited to once in a lifetime. Because bankruptcy would become an exercise in financial planning, non-attorney providers, such as accountants and financial planners, should also be allowed to prepare bankruptcy plans.

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I would ask that my testimony and attachments be placed in the record. Thank you for the opportunity to appear before you and I will be pleased to answer any questions you may have.

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Next Hearing Segment(2)

(Footnote 1 return)
Caher & Caher, *Debt Free!*, Henry Holt & Co. publishers, 1996.

(Footnote 2 return)
See, e.g., Lynn M. LoPucki, Common Sense Consumer Bankruptcy, 71 American Bankruptcy Law Journal, 461 (1997); Judge Robert E. Ginsberg, Commission Vice-Chairman (Bankruptcy schedules are the "great American novel.")

(Footnote 3 return)
Debtors who were part owners of their residence were not included in this calculation, nor were debtors whose total mortgages included those on nonresidential real property.

(Footnote 4 return)
The debtors in case 48 ran up a whopping $177,095 in credit card debt. If this case is excluded from the calculation, the average is $23,230 per debtor.

(Footnote 5 return)
§101(10A) does not state whether "income" is gross or net after withholding taxes are deducted. I assumed it was gross.

(Footnote 6 return)
Since the unsecured debt limit in chapter 13 is $250,000, they would not be eligible for chapter 13 in any event.

(Footnote 7 return)
The figures for secured car payments were mistakenly excluded from my data, but a monthly payment number can be extrapolated from the total vehicle debt. I also failed to note whether insurance and taxes were included in the mortgage payment. I gladly will provide this and any other data you seek.

(Footnote 8 return)
Report of the National Bankruptcy Review Commission, Chapter 5, "Recommendations for Reform of Consumer Bankruptcy Law by Four Dissenting Commissioners" at 61 (October 20, 1997).

(Footnote 9 return)
MBNA Corporation is a bank holding company. Its principal subsidiary is MBNA America Bank, N.A., a national bank. MBNA America Bank is the largest independent credit card lender in the world and one of the two largest credit card lenders overall. MBNA has $49.4 billion in managed loans outstanding and almost 20,000 employees in 28 offices located in the U.S., the United Kingdom and Canada.

(Footnote 10 return)
For instance, H.R. 3150 is strongly supported by the National Consumer Bankruptcy Coalition, which is comprised of

the American Bankers Association, America's Community Bankers, American Financial Services Association, Consumer Bankers Association, Credit Union National Association, Independent Bankers Association of America, MasterCard International Incorporated, National Retail Federation and VISA U.S.A. Inc.