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1999

BANKRUPTCY REFORM ACT OF 1998;
RESPONSIBLE BORROWER PROTECTION ACT; AND
CONSUMER LENDERS AND BORROWERS BANKRUPTCY ACCOUNTABILITY ACT OF 1998
PART III

HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE
COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

ON

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H.R. 3150, H.R. 2500, and H.R. 3146

PART III

MARCH 18, 1998

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Boone, Thomas H., Managing Director of Portfolio Services, Countrywide Home Loans, Inc.

Donald, Hon. Bernice B., Judge of the United States District Court for the Western District of Tennessee

Duncan, Mallory B., Vice President and General Counsel, National Retail Federation

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Newton, Grant W., Professor of Accounting, Pepperdine University

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Starr, Judith R., Assistant Chief Litigation Counsel, Division of Enforcement, The Securities and Exchange Commission

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BANKRUPTCY REFORM ACT OF 1998; RESPONSIBLE BORROWER PROTECTION ACT; AND CONSUMER LENDERS AND BORROWERS BANKRUPTCY ACCOUNTABILITY ACT OF 1998

PART III

Wednesday, March 18, 1998

House of Representatives,
Subcommittee on Commercial
and Administrative Law,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in Room 2141, Rayburn House Office Building, Hon. George W. Gekas [chairman of the Subcommittee] presiding.

Present: Representatives Ed Bryant, Steve Chabot, Lindsey O. Graham, Jerrold Nadler, Sheila Jackson-Lee, Martin T. Meehan, and William D. Delahunt.

Staff present: Raymond V. Smietanka, Chief Subcommittee Counsel; Susan A. Jensen-Conklin, Subcommittee Counsel; Susana Gutierrez, Subcommittee Clerk; Peter J. Levinson, Committee Counsel; David Lachmann, Subcommittee Professional Staff Member.

OPENING STATEMENT OF CHAIRMAN GEKAS

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

In obedience to the rules of the House, we cannot proceed without at least two members participating in such a hearing. So, we have to wait for the presence and attendance of, at least, one other member, but what I have done is to stay true to my intention of starting every subcommittee meeting on time. I've done that, but now I will recess until the appearance of the second member. [Laughter.]

So, I'll have to ask you to wait another few minutes.

[Recess.]

The subcommittee will come to order, noting the attendance of the ranking member, the gentleman from New York, Mr. Nadler. We now have a hearing quorum and we will proceed.

This morning's hearing, as in most of the hearings that have been held thus far, will focus on the proposals in the various bills, and how to address the rising number of bankruptcy filings that we have seen in recent years.

In H.R. 3150, the needs-based quotient is the subject of much discussion these days, and we have heard from people from all over the country, both at the witness table and otherwise, about the pros and cons. We have installed two charts for the purpose of illustrating what H.R. 3150, basically, does. And, the first one on the left indicates that under the Ernst and Young Study, 53 percent of individuals who come into bankruptcy are automatically, without any kind of emphasis or reemphasis, enter chapter 7, eliminated. Why? Because, they don't reach the 75 percent of the median income level. Right from the start, the gatekeeper who applies this chart ensures that these individuals receive the much needed relief under chapter 7, and they're never heard from again, so to speak, except for receiving the fresh start to which they're entitled.

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Then the next proportion, about 32 percent, also do not meet the standards that would require them to seek relief under chapter 13, because even though they may have met the income criterium that I just referred to, they do not have

enough left over, after a monthly assessment of what assets they might have in order to make any reasonable repayment. So they fall into and stay in chapter 7.

So, it remains for the balance, as the chart indicates, who are in a position under the good test that we apply to be considered as candidates for chapter 13, as they have an ability to repay, albeit it might be a small percentage, and albeit it may be for a long period of time. As a result, H.R. 3150 fulfills the double target that we have fashioned for ourselves: one, to make sure that people who are overwhelmed with debts, get that fresh start, as we have indicated in the chart; and, two, to make sure that those who are able to pay, will be able to have a structure by which they can, and do, and will repay some, or all, of their debts.

With that as background, the Chair yields to the gentleman from New York for any opening remarks that he may wish to make.

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

Today, we continue our consideration of bankruptcy legislation affecting individual debtors. We will look at how some of the details of the proposals will affect the rights of both debtors and creditors. As we look as these proposals, I hope the witnesses will focus their remarks on the practical impact of the legislation. For example, how changes in the standard of proof for making certain debts nondischargeable would function in a typical case.

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I would also be interested to hear comments from the witnesses on the Supreme Court's decision in its Associates Commercial Corporation versus Rash, and whether that decision provides a sound basis for the valuation of secured claims. As, I've commented before, Mr. Chairman, I believe that many of the issues implicated by the three bills before our subcommittee require a much more detailed review. We have made a reasonable start, but I think we really need a greater level of detail in our work.

In 1978, the House held 35 days of hearings and received, approximately, 2700 pages of testimony from more than 100 witnesses. The Senate held 21 days of hearings and received over 2300 pages of testimony from more than 90 witnesses. That legislation came 5 years after the Bankruptcy Commission recommended changes to the Code in 1973. So, I do not think, in this case, a bit more study would prove excessive, unnecessary, or unfruitful. It would probably prove beneficial to all the members of the committee. We may even discover that our differences turn out to be not nearly as great in some areas as when we began this enterprise.

But, I continue to, also, believe that a GAO review of the data being provided to the subcommittee by the various studies that have been brought before us would be beneficial.

I intend to submit a request to GAO, and although I know you have been reluctant to grant a unanimous consent for such review in the past, I hope you will, nonetheless, join the minority in making that request.

Similarly, I have received a number of written comments from trustees, and I know that we will hear tomorrow from the National Conference of Bankruptcy Judges on the subject of the cost of the system of some of the proposed changes contained in the bills before us. Costs are important in bankruptcy, because some of this money comes out of the estates, and because the rest is paid by American taxpayers. Before we raise those costs, we should have a clear understanding of how much more expensive we are making the system and what are the benefits derived from that, and whether those benefits justify that cost. Hereto for the study and additional hearings would be minimum due diligence on our part.

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Finally, I do want to conclude with a word of clarification. At last week's hearing, I expressed my frustration at the process by which this legislation is moving forward, as I have done again this morning. Although, it was not my intent,

my words conveyed to you based on what you said to me afterwards, the impression that I thought that you or the majority had been dealing with the minority in bad faith. That was not the meaning I meant to convey. What I meant to convey was a frustration at the torrid pace of the process, and the concomitant inability of the minority to participate effectively.

Although, I continue to believe that this legislation is being moved at a very ill advised pace, and that more discussion and study is necessary, I did want to clarify for you, and for the record, my concerns.

Thank you, Mr. Chairman.

Mr. **GEKAS.** We thank the gentleman. We're ready to introduce the panel which has dutifully positioned itself at the witness table.

The first witness is Judith R. Starr, Assistant Chief Litigation Counsel, and Bankruptcy Counsel for the Division of Enforcement of the Securities and Exchange Commission. She has litigated Securities' fraud cases in the Federal district courts and the appellate courts, including the United States Supreme Court.

She's is joined by Mr. Banks. Oh, I thought you were from the same entity. You're not. Okay.

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After receiving her Bachelor of Arts degree from the College of William and Mary, Ms. Starr obtained her law degree with honors from Harvard Law School where she served as an editor of the Harvard Law Review. Thereafter, Ms. Starr clerked for the Honorable Williams Schwartzer, United States District Judge for the Northern District of California. She then practiced law for several years as a commercial litigator in Los Angeles with an emphasis in securities and bankruptcy law. In 1991, she then joined the Securities and Exchange Commission. She has authored law review articles and various training materials on securities and bankruptcy litigation. She's also a frequent lecturer on the topic of law enforcement and bankruptcy.

Donald E. Banks has been employed by the Dayton Hudson Corporation since 1974 to the present. Before joining Dayton Hudson, he received his Bachelor of Arts from Luther College, and then joined the United States Army from 1968 to 1970. He, thereafter, obtained his law degree from William Mitchell College of Law in 1976. Mr. Banks is a member of the American Bar Association and the Minnesota Bar Association. In addition to serving as Vice President of the Credit Card Compliance Association, he is also the Compliance Officer and Director of Legal Services of Retailers National Bank of the Dayton Hudson Corporation. He'll be speaking on behalf of the National Retail Federation.

They are joined by Brian L. McDonnell, President and Chief Executive Officer of the Navy Federal Credit Union of Merrifield, Virginia. He will be speaking on behalf of the National Association of Federal Credit Unions. Mr. McDonnell has been President and Chief Executive Officer of the Navy Credit Union since 1996. In this capacity, he is responsible for the day-to-day operations of the Navy Federal, the world's largest credit union, with more than $95 billion in assets. He also serves as Treasurer of the Credit Union's Board of Directors.

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Over the 28 years that he has been with the Navy Federal, Mr. McDonnell has served that firm in various capacities. Prior to assuming his present position, Mr. McDonnell was Senior Executive Vice President. Before that, he was responsible for directing the firm's mortgage department. Before coming to Navy Federal, Mr. McDonnell spent 4 years on active duty in the United States Navy. For more than 20 years, he remained in the United States Naval Reserves, and retired as a captain. Mr. McDonnell appears today, as we said, on behalf of the National Association of Federal Credit Unions, where he serves as a member of its Board. He also serves on the Association's Share Insurance Liquidity and Development Fund Oversight Committee, and the Ad Hoc Bankruptcy Committee, among other positions. Born in Kingston, Pennsylvania, Mr. McDonnell received his Bachelor of Science degree from Scranton

University, and his Masters Degree in Business from George Washington University.

And, they are joined by Judith Greenstone Miller, Legislative Counsel, Bankruptcy & Insolvency Section of the Commercial Law League of America based in Detroit. Judith Miller is a member of the law firm of Clark Hill where she focuses on bankruptcy and insolvency, creditor's rights, and commercial litigation. She has represented debtors, secured and unsecured creditors, creditor's committees and trustees, primarily in chapter 11, and bankruptcy cases. She has also represented parties in complex commercial litigation cases. Ms. Miller is a graduate of the University of Michigan where she obtained her Bachelor of Arts degree Cum Laude. Thereafter, she obtained her law degree Cum Laude from Wayne State University of Law.

Ms. Miller appears today on behalf of the Commercial Law League of America. She serves on the League's Legislative and Education Committee, and has been a government-working group leader for the League which assisted the National Bankruptcy Review Commission.

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And, the Honorable Bernice Bowie Donald, United States District Court Judge from the Western District of Tennessee fills out our panel. She has served as United States District Court Judge for the Western District of Tennessee since 1996. Prior to that, Judge Donald was a bankruptcy judge from 1988 to 1996, also in the Western District of Tennessee.

Judge Donald has been an adjunct professor at the University of Memphis, Cecil C. Humphrey School of Law from 1984 to 1989. She is a member of numerous professional organizations, including the American Bar Association, where she chaired the Commission on Opportunities for Minorities in the Profession, among other positions. Judge Donald was past president of the National Association of Women Judges and has served on the faculty of the Federal Judicial Center. Judge Donald holds the distinct honor of being the first African American female bankruptcy judge in the United States. She is also the first African American female to serve on the Federal District Court bench in Tennessee.

We welcome all of the participants and, as is our custom, we announce to you ahead of time that your written statement will automatically become a part of the record without objection. And, we will ask each individual to summarize their written statement in the oral presentation, to be kept within 5 minutes if, reasonably, it can be accomplished.

So, we will start with our first witness, Ms. Starr.

STATEMENT OF JUDITH R. STARR, ASSISTANT CHIEF LITIGATION COUNSEL, ENFORCEMENT DIVISION, THE SECURITIES AND EXCHANGE COMMISSION

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Ms. **STARR.** Thank you Chairman Gekas, Congressman Nadler. I would like to thank you very much for the opportunity to present the views of the Division of Enforcement of the Securities and Exchange Commission on bankruptcy reform.

The Division of Enforcement is the law enforcement arm of the Securities and Exchange Commission, and has stood at the intersection of two disturbing trends over the past several years: the rise in securities fraud, and the rise in bankruptcy filings, and together that has packed a real one-two punch to the enforcement attorney.

I am here today to express our concerns about the adverse impact that certain gaps and ambiguities in the current system have on our law enforcement efforts, to express our support for provisions in H.R. 3150 that address some of these concerns, and to propose additional fixes that we think would help round out the solution to these problems.

While the issues that we face on a regular basis in the bankruptcy courts arise from the conduct of the minority of debtors—debtors who are alleged to have committed, or have been found to have committed, securities fraud—these are, nonetheless, important issues that affect the entire system, as I think that some of the changes in H.R. 3150 recognize. This is because not only does this have a substantial affect on law enforcement activities by us and by our fellow regulatory agencies at both national and state level, but also because it affects the public perception of the system. A system that looks like it is malleable, and easily subject to abuse by those who are unscrupulous or engage in defrauding the public is not a system that the public can have a lot of confidence in.

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So, we hope that even though our concerns are a very small subset of the bankruptcy concerns compared to those of the millions of honest debtors that are filing to address their debts that this subcommittee is trying to address, we hope that, nonetheless, these problems will be given your attention as well.

Specifically, we do not believe the privilege of a fresh start should extend to those who lie, cheat, and steal from the public. But the lack of proper notice provisions, the lack of accountability for important and basic disclosure documents in a case that creditors have to rely on, restrictive deadlines, the ability to discharge debts, such as fraud debts in chapter 13, combine to favor the unscrupulous debtor without providing a concomitant benefit to the honest debtor who wants to play fair, who wants to abide by the rules, who wants to have a fresh start.

The Division of Enforcement believes that one of the most basic improvements that can be done in the system is to make sure that it does not offer inducement to those who are dishonest. And, one of the provisions that we strongly support in H.R. 3150 that it does so, is Section 143, which addresses what's called the "superdischarge" in chapter 13, which enables people who go through chapter 13 to discharge fraud debts and other debt that arise out of intentional misconduct.

We strongly agree with the proponents of that bill that such conduct should not be dischargeable in bankruptcy. It certainly does not further any kind of a public policy to give benefits to the dishonest that are not available to the honest. We would suggest an addition to that bill to add fines and penalties that are nondischargeable in other chapters under 523(a)(7).

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Under our statutes, fines and penalties are reserved for the most egregious offenders, and we think that it would not serve public policy well to continue with a hierarchy that permits those who are the most egregious offenders to get the most benefits out of filing bankruptcy. That is exactly backwards, the way a fair system that should encourage people to be honest and play by the rules should work.

I see I'm getting an orange light, so I'm going to try and talk faster.

We support the Fair Notice to Creditors Provisions in sections 405 and 503. Right now, the notice provisions do not work as well in bankruptcy as they do elsewhere in the civil system, and can sometimes operate as a real "gotcha" trap when, what is considered to be actual notice, is notice to a government without any kind of a proper address that can go around to many, many different offices without getting anywhere.

And, important substantive rights should not be forfeited without a creditor having a fair opportunity of notice, and an opportunity to be heard. We would suggest that the provisions be tightened to ensure that deadlines that are not pegged to notice, that are just strict deadlines pegged to other happenings in the case, not be able to run at all until the notice provisions are complied with. This will discourage gamesmanship and provide the maximum incentive for debtors to get notice to their creditors so that everybody can participate in the case to the extent that they wish to.

We also would ask this Congress to look at 11 U.S.C. 105, the bankruptcy injunctive power, which has been used in certain cases to enjoin government actions. Outside of bankruptcy, there's a very high threshold for ever stopping a

governmental regulatory proceeding, be it an investigation or a lawsuit. There are many Supreme Court cases on this subject and, as my written statement shows, there have been a number of cases which have been forced to be litigated throughout the country where, nonetheless, such actions have been enjoined. This is a great burden on both state and federal agencies to have to litigate this and take up to appeals court their right to, basically, do their statutory job.

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We would suggest that the statute explicitly conform to the standard that the Supreme Court has enunciated in nonbankruptcy law and we have that in my written statement.

I see that I am running out of time. I would just like to close by asking the subcommittee to address the law enforcement issues, as well as the issues facing the majority of honest debtors so that we will have a system that does not hinder law enforcement, and that is something that consumers and investors can have confidence in.

[The prepared statement of Judith R. Starr follows:]

PREPARED STATEMENT OF JUDITH R. STARR, ASSISTANT CHIEF LITIGATION COUNSEL, DIVISION OF ENFORCEMENT, THE SECURITIES AND EXCHANGE COMMISSION

Chairman Gekas, Congressman Nadler, and Members of the Subcommittee:

On behalf of the Division of Enforcement of the Securities and Exchange Commission, I welcome the opportunity to present this testimony on the topic of bankruptcy reform. This testimony represents solely the views of the Division staff and has not been approved by the Commission. Over the last several years, the Division's workload has been affected by the intersection of two disturbing trends: the rise in securities fraud occasioned by the burgeoning market, and the rise in bankruptcy filings. While we do not have data on the causes for the general rise in bankruptcy filings, we have observed that defendants in our law enforcement actions have been filing bankruptcy in record numbers as a litigation tactic to escape what they perceive as unfavorable forums, and to increase cost and cause delay by enmeshing the government in collateral litigation. Other federal and state agencies with whom we have discussed the issue have corroborated our experience.

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Defendants in our cases have filed bankruptcy in attempts to stop law enforcement proceedings, to collaterally attack asset freezes and receiverships, to obtain stays of judgments pending appeal without posting a bond or meeting the stay criteria, and to try to discharge nondischargeable claims.(see footnote 1) After having tried and won fraud cases and successfully defended them on appeal, scarce enforcement resources have been expended in duplicative and lengthy dischargability litigation in the bankruptcy court. Potential defendants also have sought to use the bankruptcy process to interfere with ongoing investigations by seeking relief that is not available under substantive nonbankruptcy law. Bankruptcy filings by individuals implicated in our investigations have forced our staff to disclose the existence of nonpublic investigations early in the investigatory process or risk forfeiting the ability to obtain disgorgement of fraudulently obtained proceeds for return to injured investors.

We believe that, in enacting the Bankruptcy Code, Congress never intended to extend the privilege of the "fresh start" to those who lie, cheat, and steal from the public. Yet the bankruptcy process is amenable to abuse by the unscrupulous, through the existence of gaps and ambiguities in the Code. The process also contains certain inherent unfairness such as lax notice provisions, which, combined with strict deadlines that have been held to be jurisdictional, can effectively cause forfeitures of important rights. Exacerbating these problems is the lack of effective deterrents against abuse.

A fair consumer bankruptcy system should help honest but unfortunate debtors get their financial affairs back in order by providing benefits and protections that will help the honest to the exclusion of the dishonest, and not vice versa. It is an anomaly of the current system that bankruptcy is often more attractive to persons who commit fraud than

to their innocent victims. Bankruptcy should not be a refuge for those who have committed intentional wrongs, nor should it encourage gamesmanship by failing to provide real consequences for abuse of its protections. There are a number of useful provisions in pending legislation that address these problems, which we support, and there is more that can be done, which we outline below.

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Fair Notice. We support Section 405 of HR 3150, "Giving creditors fair notice in chapter 7 and 13 cases." This is an issue especially important to the government. We have observed numerous instances of debtors who, despite having dealt directly with a particular individual at the Division of Enforcement, send bankruptcy notices to one of our offices without any identifying case information, office, division or staff member, so as to be able to claim we were given actual notice of the case, while ensuring that any notice received would be untimely. Other federal and state agencies have described similar experiences to us.

As drafted, however, Section 405 only protects a creditor who has not received appropriate notice from being sanctioned for violating the stay and turnover provisions (the special governmental notice provision of Section 503 does not expressly relieve the government from the running of deadlines). We believe it could be improved by extending it to protect any creditor who has not received appropriate notice from the forfeiture of substantive rights. Therefore, we suggest it be amended to relieve a creditor from the running of deadlines fixed by the Code and Rules, such as those for filing an adversary complaint or objecting to claims of exemptions, until such time as the notice provision is complied with by the debtor. Creditors should be entitled to the best notice that is reasonably possible under the circumstances before they lose important rights—a standard that is applicable in all other areas of civil law.

Increased Accountability. The Division supports Section 411 of HR 3150, expressing the sense of Congress that Rule 9011 of the Federal Rules of Bankruptcy Procedure be modified to include a requirement that debtors and debtors' counsel make a reasonable effort to verify the accuracy of documents, such as schedules, submitted to the court. Currently, there is no consequence for making improper claims in the schedules, such as claiming frivolous exemptions, which if not objected to will be unassailable(see footnote 2)—the only risk is that they will be disallowed. Only by holding debtors and their counsel accountable for these important disclosure documents can the system adequately police itself.

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Preserving Fraud Debts from Discharge. We support Section 143 of HR 3150, which makes fraud debts nondischargeable in Chapter 13 cases. Inducements to file under Chapter 13 rather than Chapter 7 should be aimed at honest debtors, not at those who have committed fraud. We recommend that this provision be expanded to include debts that are nondischargeable under 523(a)(7) (fines, penalties or forfeitures payable to a governmental unit). In our cases, fines are levied on the most egregious offenders—the very people least entitled to special advantages under the law. Moreover, as the effect of 11 U.S.C. 1325(a)(4) is to subordinate fines, penalties and forfeitures to general unsecured claims, unless they are nondischargeable, they will be erased with no payment ever being made. The civil penalties Congress added to our arsenal of remedies in 1990 lose much of their deterrent effect if they can be eliminated with the filing of a Chapter 13 petition. Incentives to file Chapter 13 should be based on benefits to the honest debtor—who derives no benefit from the ability to discharge penalties and fines—not on benefits that adhere solely to the dishonest debtor.

Consistent Treatment for Nondischargeable Governmental Claims. We have noted in the past several years an increase in the number of individuals involved in our investigations who file bankruptcy at the outset of the investigatory process. Indeed, to address this issue, in 1996 the Commission amended its rules to provide the Director of the Division of Enforcement with delegated authority to permit the staff to appear in bankruptcy court and disclose the existence of a nonpublic investigation where necessary to protect potential Commission claims against the debtor. *See* 17 C.F.R. 200.30–4.

When such a filing occurs, we have a choice. We can continue with our nonpublic investigation and ignore the

bankruptcy case. If we do so, we will retain our ability to seek civil fines against the debtor in a Chapter 7 or 11 case if an enforcement action is subsequently authorized, because civil fines and penalties are automatically nondischargeable under 11 U.S.C. 523(a)(7). However, we will lose our ability to seek the return of funds to defrauded investors, because the nondischargeability of fraud claims under 523(a)(2)(A) must be litigated as an adversary proceeding under 523(c), which must be brought within 60 days of the first meeting of creditors under Bankruptcy Rule 4007(c).

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Alternatively, we may appear in the bankruptcy, seek extensions of time to file a dischargeability complaint (which are discretionary with the bankruptcy court), and ask the bankruptcy court to defer action pending the filing and adjudication of a securities fraud action in the district court. The outcomes of these discretionary decisions vary, and, of necessity, may depend more on the scheduling needs of the bankruptcy case than on the public interest to be vindicated by the law enforcement action.

We do not believe that the pace or scope of a fraud investigation should be dictated by an individual's bankruptcy case, and the fact that this is currently the case presents an invitation to abuse. There is no sound basis in public policy for treating the government's ability to obtain disgorgement or restitution of fraud proceeds less favorably than its ability to fine such wrongdoers. Rather, when the government exercises its role as the guardian of the public to detect, remedy and deter fraud, none of the claims arising therefrom should also have to be litigated in a bankruptcy court. All the government's remedies for the fraud should be treated equally, as nondischargeable under 523(a)(7).

The opportunity cost to our enforcement program caused by the diversion of scarce enforcement resources into dischargeability litigation provides further support for this change. In some cases, it has taken years of litigation to establish that particular Commission fraud judgments are nondischargeable debts for money obtained by fraud.(see footnote 3) This diversion of enforcement resources at a time when, by all indications, securities fraud is rising, disserves the public.

Accordingly, the Division of Enforcement recommends that Congress amend 523(a)(7) to include disgorgement and restitution obtained by a governmental unit.

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The scope of the police power/regulatory exception to the automatic stay. The Division of Enforcement supports the amendments to 11 U.S.C. 362(b)(4) & (5) contained in S. 610, and H.R. 2709. These bills clarify that governmental action to enforce the police or regulatory power is excepted from the provisions of the automatic stay applicable to actions to obtain possession or exercise control over property of the estate (362(a)(3)) and to collect, assess or recover on a claim (362(a)(6)). They correct what appears to be an unintentional gap in the scope of the governmental stay exception, and accord with recent appellate authority that such a gap was not intended.(see footnote 4) These amendments ensure that governmental action to revoke licenses, appoint receivers and impose interim asset freezes will not be disrupted by forum shopping, but will continue to be adjudicated in the forums designated by Congress and the state legislatures. We strongly support the retention of this language in conference and its enactment into law.

Abuse of bankruptcy injunctions. Under nonbankruptcy law, a defendant in a law enforcement action, or a person implicated in an investigation, cannot sue a governmental entity to halt or modify the action or investigation except under the most extreme circumstances, where it is undertaken for the purpose of harassment, in bad faith, or is clearly illegal.(see footnote 5) However, some bankruptcy courts have used their injunctive power under 11 U.S.C. 105 to enjoin governmental action in a manner that they could not do outside of bankruptcy, either to stay governmental action that is excepted from the automatic stay, or to impose requirements on the government that are not provided by the applicable statutory scheme.(see footnote 6) While such injunctions often are set aside on appeal,(see footnote 7) the appellate process can be time-consuming and it diverts scarce resources from law enforcement. As there currently is little appellate authority in this area, we can expect to continue to have to litigate such injunctions jurisdiction by jurisdiction.

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The Code should clearly state that bankruptcy is not available for forum-shopping by law violators. Section 105 should be amended to provide that no injunction shall issue against a governmental action that is excepted from the automatic stay unless the action poses a direct conflict with a provision of the Bankruptcy Code (i.e., where there is specific provision in the Code governing an act, such as the rejection of a labor contract or the issuance of securities under a plan of reorganization). This standard ensures that the filing of bankruptcy is not used as a means to alter substantive nonbankruptcy rights and duties prescribed by this Congress and the state legislatures, while preserving the integrity of the Bankruptcy Code.

Comments on the Bankruptcy Rules. The Division of Enforcement recognizes that this Congress is concerned with bankruptcy legislation, and that reform of the Rules of Bankruptcy Procedure is the work of the Committee on Rules of Practice and Procedure. Nonetheless, we would like to make the Congress aware of instances where the Rules undermine substantive rights created by the Code, in derogation of 28 U.S.C. 2075. The trend in recent amendments, as shown by the attached letter our General Counsel sent to the Committee on Rules of Practice and Procedure in opposition to a recently proposed amendment to Rule 7001, appears to be toward even fewer procedural protections for substantive rights. *See* Exhibit A.

We are specifically concerned with deadlines in the Rules for the enforcement of creditor rights. For example, Rule 4004 governs the time for objecting to the discharge of a debtor under 11 U.S.C. 727, which bars discharge on the basis of various fraudulent acts, such as false testimony, concealment of assets and fraudulent transfers—conduct that can occur prepetition or at any time during the bankruptcy case. The logical import of the statute is that such conduct is the basis to deny discharge no matter when it occurs in a bankruptcy case. However, Rule 4004 provides that a 727 complaint must be filed within 60 days of the date first set for the first meeting of creditors. The burden is on the creditors or trustee to file a motion for an extension of time and establish cause for an extension to the bankruptcy court's satisfaction.

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Under the plain language of the rule, if a debtor commits an act within the scope of 727 more than 60 days after the date for which the first meeting is scheduled, the creditors must wait for the debtor to be discharged and then bring an action to revoke the discharge. While some courts have held this to be an absurd result, and have essentially rewritten Rule 4004 to permit the filing of 727 complaints after the deadline, having to judicially rewrite the rule, with no textual support, is not a satisfactory solution. A fair and reasonable rule would permit the filing of a 727 complaint within a reasonable time after a creditor or trustee learns of the violative conduct.

In the 1994 amendments to the Code, Congress recognized the special problems of government in assessing claims within the strict deadlines of the Bankruptcy Rules, and amended the Code to allow governmental agencies 180 days from the date of a bankruptcy filing to file a claim. *See* 11 U.S.C. 502((b)(9). However, governmental agencies with claims potentially excepted from discharge under 523(a)(2), (4) or (6) are still subject to the deadline of Rule 4007 that they file an adversary complaint within 60 days of the date first set for the first meeting of creditors, thus depriving governmental creditors with claims arising from the debtor's intentional misconduct of the benefit of the extended period to investigate their claims. We believe that for the 180-day deadline to be meaningful, the Rule should provide the same deadline for governmental adversary complaints.

The manner in which creditor deadlines are fixed in the rules also has not worked well in practice. Rule 4003 (deadline for objecting to claims of exemptions), like Rules 4001 and 4007, is pegged to the date first set for the first meeting of creditors, and requires objections to be filed no more than 30 days later. The courts have held that the continuance of the meeting, even at the debtor's request (not an infrequent occurrence) does not change the deadline. Rather, the burden and expense fall on creditors to go into court and move for an extension of time. Given that these meetings are often continued, it is wasteful and burdensome to peg these deadlines to the date the first meeting is scheduled, rather than after it has been held and completed. Creditors and trustees should have a fair opportunity to question the debtor before important deadlines in the case expire.

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Conclusion. The bankruptcy system has a substantial impact on the efforts of the Division of Enforcement of the Securities and Exchange Commission to enforce the federal securities laws effectively. The Division supports the efforts within this Congress to enhance accountability, and to deter those who would abuse the system to hinder law enforcement. We welcome the opportunity to assist in the cause of reform as the process continues.

United States
Securities and Exchange Commission,
Washington, DC, March 6, 1998.

Peter G. McCabe, *Secretary,*
Committee on Rules of Practice and Procedure,
Administrative Office of the U.S. Courts, Washington, DC.

Re: Proposed Amendment to Bankruptcy Rule 7001

DEAR MR. MCCABE: The staff of the Securities and Exchange Commission opposed the proposed amendment of Federal Rule of Bankruptcy Procedure 7001, which eliminates the requirement that an adversary proceeding to be commenced to obtain an injunction when such relief is provided in a chapter 9, chapter 11, chapter 12, or chapter 13 plan. Experience to date with injunctions incorporated in plans, which has occurred even in the absence of authorization under the Bankruptcy Rules, suggests that ratifying this procedure would impair important procedural rights of those subject to bankruptcy court injunctions.

Under the current version of Rule 7001, a person to be enjoined must be properly served with all supporting papers, the relief sought must be specifically described and limited in scope, with a well-established test weighing the balance of interests must be applied. Injunctions incorporated in plans do not carry such safeguards. We have reviewed many plans incorporating injunctions that are not prominently displayed and whose effect is not adequately described in disclosure statements. Such injunctions can readily slip by not only the affected party, but also by the court that is approving the plan. For example, in *In re Arrowmill Development Corp.*, 211 B.R. 497 (Bankr. D.N.J. 1997), a plan of reorganization provided that the discharge injunction would extend to all liability on each allowed claim with respect to any equity interest holder, and that plan confirmation would discharge all claims against the debtor's equity holders or affiliates. In subsequent litigation by a creditor against a shareholder of the debtor, the state court found that even an experienced bankruptcy attorney would not have recognized the effect of these provisions, and that their scope and effect was never made clear during the confirmation process. The matter was returned to the bankruptcy court, which ruled that the provisions were not effective against the creditor because they function as a discharge of a nondebtor in derogation of 11 U.S.C. 524(e).

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The *Arrowmill* court expressly rejected the holding of two circuit courts, which had found a collateral challenge to a plan injunction barred by res judicata. *See Republic Supply Co.* v. *Shoaf*, 815 F.2d 1046 (5th Cir. 1987); *Monarch Life Ins. Co.* v. *Ropes and Gray*, 173 B.R. 31 (D. Mass. 1992), *aff'd*, 65 F.3d 973 (1st Cir. 1995). These cases raise the troubling prospect that a party who was enjoined without having had the procedural protections available in any other injunctive setting, would nonetheless be found. Given that the plan confirmation process does not focus on the rights of any one creditor, but is class oriented, and that plan injunctions are not subject to the limitations of Rule 7065 as to who may be bound, such an outcome would raise serious due process concerns.

Specifically, embedding an injunction in a plan, rather than requiring an adversary proceeding, shifts the burden from the debtor to the party sought to be enjoined. Rather than require full disclosure of the scope of the relief and its effect, the burden is on the creditor to discern it in the often lengthy and jargon-laden plan documents. Rather than require the movant to make the well-established showing of the necessity for the injunctive relief, the burden is on the creditor to come into court and object to the plan, under a statutory scheme that does not accord the same weight to his

interests as the injunctive criteria. Appealing a confirmation order is onerous—if a stay is not obtained or a bond posted, the doctrine of substantial consummation may lead to a forfeiture of appellate rights.

In the course of our investigations, we have reviewed plans that purported to extinguish law enforcement claims against directors, officers and affiliates of the debtor. While we thus far have been successful in persuading plan proponents to drop such provisions, we do not believe that the burden should be shifted to law enforcement authorities to come into bankruptcy court and prove why they should not be enjoined, or risk being foreclosed even by a clearly unlawful injunction. Yet the proposed amendments carry with them this very risk.

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There is no evidence that the current version of Rule 7001 is sufficiently impairing the interests of debtors or others to counterbalance the fairness concerns raised by the proposed amendment. Accordingly, we urge that the amendment be rejected.

Sincerely,

Richard H. Walker, *General Counsel.*

Mr. **GEKAS.** Yes. I'm sure we'll get back to you during the question and answer portion of today's activities.

We'll turn to Mr. Banks. Thank you, Ms. Starr.

Ms. **STARR.** Thank you.

STATEMENT OF DONALD B. BANKS, DIRECTOR OF LEGAL SERVICES, HUDSON CORPORATION, REPRESENTING THE NATIONAL RETAIL FEDERATION

Mr. **BANKS.** Good morning. Thank you for this opportunity.

My name is Don Banks. I'm the Compliance Officer and Director of Legal Services for Retailers National Bank, a wholly-owned subsidiary of Dayton Hudson Corporation. I'm pleased to be testifying here on behalf of the National Retail Federation.

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Dayton Hudson operates a full spectrum of department stores under the names of Target, Meryvn's, Marshall Fields, Hudsons, and Daytons. Credit sales on cards issued by our bank were approximately $4.5 billion in 1997. Our credit losses beginning in 1995 were about $22 million. In 1996, about $36 million. In 1997, they were about $50 million.

I'm a Consumer Creditor Compliance lawyer, not a bankruptcy practitioner, but I'm here because I believe I can offer you practical information on the workings of the credit card industry, information you need to make the difficult policy choices you face in amending the Bankruptcy Code. You need this information because, in my opinion, opponents of bankruptcy reform are making charges that irresponsible lending, primarily, by credit card issuers, is the cause of the bankruptcy proliferation. Those charges are false.

My written testimony describes the process we go through in determining whether to extend credit. It's a process we are constantly refining because we know that we have to lend responsibly to stay in business. We also understand that financial problems can devastate lives and families. The reforms we are seeking do not target the people who have been devastated by job loss, illness, divorce, or the like, even if unwise credit use is what left them vulnerable to those events.

Our focus on lending responsibly doesn't stop when we issue a credit card. We monitor use of the card and payment

history to look for signs that the cardholder's credit line is at risk or can be safely increased. We are trying methods of working with data beyond our own experience, information from consumer reporting agencies, for instance, to give us earlier warning signs of potential trouble. Some issuers are going even further testing algorithms which use the nature of purchases on credit cards to look for information that could mean the holder is headed for financial trouble.

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By now, you've spotted the conflict between the creditor's need for predictive data that are complete and accurate and the cardholder's demand for privacy. We must, also, balance our need for data against the expense of obtaining it, its reliability, and the cardholder's expectations of fast service. Even then, some data, such as current income, is not available to most creditors—current income.

Because we do the best job we know how deciding whether to open an account, almost all of our cardholders pay us. Knowing this, we have to ask where is the responsible place to draw the line in terms of going after more information. Our mathematical models give us a starting point, but they are developed using our experience with people's behavior. Behavior changes over time.

The explosion of bankruptcy is evidence that there has been a significant shift in the behavior of a segment of the population that now looks for easier financial solutions. That shift decreases the accuracy of our models. As good as we may get, there will be opportunities for people to get credit from us that they have no prospect or intent of repaying. We need bankruptcy protections that discourage people from lying to us and using their available credit in a pre-bankruptcy shopping spree, or in paying off other debts that would be more difficult to discharge in bankruptcy.

The Code recognizes and deals with some of the strong temptations to manipulate the system, such as, the provisions on preferential payments and fraudulent conveyances. However, the movement of a debtor's assets from nonexempt to exempt property has an equally human temptation that the Code does not deal with adequately.

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Similarly, some people believe that unused available credit is an asset that can be tapped on the eve of filing and used to better position the debtor for life after a bankruptcy discharge. I once described the hypothetical act of taking a cash advance against a credit card to pay the bankruptcy filing fee and attorney's fees as stealing. I was naive enough to be shocked because people at the table said "no, it wasn't."

Congress must deal with loading up in bankruptcy reform legislation. Currently, there is no uniform rule as to what is allowed in this context. That is, in part, because the difficulty of proof of fraud. A law which depends on a set of shared social values for its successful enforcement is open to abuse by those whose values differ from the perceived consensus. In addition to a set of clear and appropriate guides to qualify a debtor for bankruptcy's extraordinary relief, there needs to bet a set of clear and appropriate sanctions against behavior in the nature of fraud which abuse the system. H.R. 3150 contains those reforms. Thank you.

[The prepared statement of Mr. Banks follows:]

PREPARED STATEMENT OF DONALD B. BANKS, DIRECTOR OF LEGAL SERVICES, HUDSON CORPORATION, REPRESENTING THE NATIONAL RETAIL FEDERATION

INTRODUCTION

Thank you for this opportunity to testify. I am a credit compliance lawyer. I work for Dayton Hudson Corporation and its wholly owned subsidiary Retailers National Bank. I am pleased to be here today on behalf of Dayton Hudson Corporation but the views I express are broader and are shared by other members of the National Retail Federation, the world's largest retail trade association. RNB is a credit card bank chartered in 1994. Dayton Hudson Corporation operates a full spectrum of department stores under the names of Target, Mervyn's, Marshall Field's, Hudson's and

Dayton's. Credit sales on cards issued by RNB totaled approximately $4.5 billion in fiscal 1997. In 1995, our credit losses due to bankruptcy were about $22 million. In 1996 they were about $36 million. In 1997 they were approximately $50 million.

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OVERVIEW. A BRIEF SUMMARY OF THE TOPICS TO BE ADDRESSED IN THIS WRITTEN TESTIMONY.

Credit Underwriting

The popular myth of reckless lending needs careful examination. The fact is lenders do underwrite loans. We use tremendous resources to try to determine who, among the people who want credit, is likely to repay the loans they want. We sometimes reject more than half of the credit applications we receive. Other creditors with typically higher credit line offerings may reject two thirds or more of the applications they receive. Prescreening can filter out similar numbers of names on lists of potential direct mail offerees. We do our best to make correct decisions before we offer credit, before we accept an application for credit, and before we extend credit at point of sale. We also periodically review the credit accounts in our portfolios to determine whether to raise or lower credit lines.

Discharging Debts

There is a small but dangerous number of debtor's who abuse the bankruptcy process through manipulation of assets and use of credit on the eve of bankruptcy. Many, probably most, debtors wait to get financial advice until the last minute when there is no time to engage in "bankruptcy planning." Yet as many as half of the bankruptcy notices received by retail creditors now relate to accounts that are not delinquent at the time the petition is filed. This and other evidence that bankruptcy is no longer a last resort for many people require that we examine and limit the potential for abuse in areas such as using non-exempt assets to acquire exempt property prior to filing and using open lines of credit at times and in circumstances which indicate that the debtor likely expects to have the credit discharged in bankruptcy. Leaving loopholes in the system not only creates opportunity for misuse, it also weakens people's confidence in the fairness of the system when they realize they are paying for someone else's gain.

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Exemptions

If Congress believes that it is appropriate for each state to have the right to define exempt property for its residents, then there is a need to prevent debtors abusing those exemptions by moving, leaving the creditors behind holding the bag.

Administrative Improvements

Creditors face unnecessary additional costs and risk sanctions for violation of the automatic stay when routine notices of bankruptcy are sent to the wrong address or don't contain enough information to accurately identify the debtor and the account.

CREDIT UNDERWRITING

We at Dayton Hudson take our underwriting efforts seriously and we are successful far more than 9 out of 10 times as evidenced by the number of account holders who pay us without significant default.

No one receives a new credit card account unless they have requested it.

The processes we use to evaluate mailed and point of sale applications are identical and rigorous. We determine whether the applicant has had a previous account with us and, if so, the payment history. Then, we check for signs of a

fraudulent application. Next, we obtain the applicant's credit history file from one or more credit reporting agencies. With this information, we use a risk assessment model to calculate a score for the application and the applicant's credit history. All of these steps are done quickly, by computer. For some applications, the process slows down while we do additional investigation and verification where information seems questionable, inconsistent or marginal. Finally, for approved applications, we assign an initial credit limit and establish the account. In addition to this process of evaluation, applications submitted at point of sale are screened for identity before the application is submitted for evaluation.

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The risk assessment models we use vary with our portfolios, the method of application, and the applicant's broad geographic region. Each model we use was developed from analysis of our own experience. Rather than being generic or actuarial estimations, they are designed as custom, objective predictors of each applicant's creditworthiness as an individual.

We extend pre-approved credit offers to people we identify in a number of ways. Some may already have a customer relationship with our company. Some may live in a geographic area from which we expect to draw customers to new stores our company is opening. The important fact to realize is that regardless of the source of the list of names, we only offer pre-approved credit to people on the list who meet criteria we specify to the credit bureau we hire to screen the names. We specify the screening factors to ensure that the screened list includes only credit worthy of individuals to whom we will offer credit.

We have been able to sharpen our tools for the evaluation of credit risk associated with individual applicants and cardholders to a degree far superior to that achievable in the past. This in turn has helped us to extend credit to a broader spectrum of the population without causing a meaningful increase in credit losses. We believe this is responsive to the public policy we perceive from laws such as the Equal Credit Opportunity Act and the Community Reinvestment Act.

Our credit underwriting doesn't end when we issue the credit card. We monitor credit usage and payment history account by account so that we can modify credit limits as appropriate. We develop algorithms to guide us when an account holder asks for credit limit increases. We are continually looking for ways to better judge the risk associated with an individual and stop use of the account where warranted and permit greater use of the account where appropriate.

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DISCHARGING DEBTS

We began a series of actions designed to tighten up our credit granting criteria a few years ago. However, our bankruptcy losses in absolute dollars and as a percentage of all credit losses have accelerated alarmingly. In my opinion, increasing amounts of these losses result from flaws that have existed in the statutory scheme and that have come to light recently through judicial interpretation and greater debtor awareness of the impact of these flaws, combined with disappearing reluctance by individual debtors to use bankruptcy as a way out of financial difficulties. This was not a problem at a time when the natural filters of social and economic stigma were working to limit bankruptcy relief to those who truly needed it. Increasingly, notices of bankruptcy filings surprise creditors. Almost half of the time the debtor has shown no serious delinquency prior to the notice. That is evidence that the stigma formerly attached to bankruptcy has faded significantly and that debtors are using bankruptcy as a first choice when they feel financial pressures rather than a last resort when they have a financial disaster.

All responsible creditors recognize that there is a true need for bankruptcy relief in appropriate circumstances. I would agree that most of the bankruptcies we see today are appropriate relief for debtors who, realistically have no other choice. But I believe the socio-economic purpose for bankruptcy relief should remain the return of the bankrupt to the status of an economically productive member of society and of the economy, with minimal societal cost.

Bankruptcy should not exist for the purpose of giving everyone a complete fresh start (or head start) on request. Certain behavior in the nature of fraud needs to be proscribed, not only in an attempt to compel payment of debts so incurred but to give a clear message regarding the honesty our society demands of everyone.

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Consider the conflict between the bankruptcy attorney's professional obligations to represent his or her client zealously to the fullest extent permitted by law and the goals of bankruptcy to provide an ordered and fair distribution to creditors in balance with a fresh start for the debtor which will return him or her to a productive participation in the economy. . However, bankruptcy is a zero sum process. Every dollar distributed to creditors is a dollar not available to the debtor's fresh start, and every dollar sheltered for the fresh start is a dollar not available to repay debt.

The code recognizes and deals with some of the strong temptations such as preferences and fraudulent conveyances. However the movement of a debtor's assets from those things which aren't exempt from being property of the estate to those things that are is an equally human temptation that the code does not deal with adequately. At which time is bankruptcy so inevitable that the debtor's restructuring of assets to take advantage of the bankruptcy laws is wrong? Is it when they seek bankruptcy advice from an attorney? Is it some arbitrary date prior to filing the petition and if so, how far in advance of the filing is reasonable so that our collective sense of right and wrong is satisfied?

Similarly, some people believe that unused available credit is an asset that can be tapped and used to better position the debtor after discharge in bankruptcy.

I once described the hypothetical act of taking a cash advance against a credit card to pay the bankruptcy filing fee and attorney's fees as "stealing." I was naiAE4ve enough to be shocked when a bankruptcy attorney at the table said "no" it wasn't. That is an irreconcilable difference of convictions. The parties won't be able to reach a middle ground on this issue. Congress must deal with "loading up" in bankruptcy reform legislation. Currently, there is no uniform rule as to what is allowed in this context. That is in part because of the difficulty of proof of fraud. More objective tests such as those in H.R. 3150 are needed to stem this abuse before it goes out of control.

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Giving individuals more relief than they need distributes excessive losses to all of society including other borrowers. And the fact is, these other borrowers have financial challenges that look very much like those faced by the people who are in bankruptcy.

EXEMPTIONS

H.R. 3150 would require an individual to be resident in a state for a year before taking advantage of any peculiar generosity in that state's exemption laws. This is a reasonable compromise between those that would set a nationally uniform schedule of exemptions and those that argue each state is in the best position to determine what it's resident's need for an effective fresh start. One of the problems is that there are greater diversity of needs with different regions of a state than there are across some state boundaries. A year is probably sufficient to deter all but the most determined from forum shopping for bankruptcy and is probably long enough to permit diligent creditors to get relief in the courts.

ADMINISTRATIVE IMPROVEMENTS

We also support the important provisions in H.R. 3150 which reduce the administrative nightmare that creditors experience when notices of bankruptcy are misdirected or do not contain enough information to properly identify the debtor and the account affected.

The bankruptcy losses from discharge are increased because of the resources needed to decipher the notices and the risk of sanctions for violating the automatic stay when the notice doesn't reach an office of the creditor which is equipped to deal with the bankruptcy.

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CONCLUSION

A law which depends on a set of shared social values for its successful enforcement is open to abuse by those whose values differ from the perceived consensus. The lessons learned from the difficulties of attempting to legislate societal values should inform us of the futility of relying on shared values to provide an effective control in any system where legislation is intended to control economic behavior.

If, in fact, the jump in the rate of consumer bankruptcy losses is due in part to the vanishing economic stigma of bankruptcy, the solution is a system that affords only as much relief as a debtor really needs. Bankruptcy is an artificial element in a market economy. Additional artificial elements put in place to control market behavior are not going to be as effective as restricting the impact of the already present artificial element of bankruptcy. Creditors do realize that there is a class of debtors legitimately needing relief in bankruptcy. The objectives of the industry do not include punishing debtors. However, there needs to be a set of clear and appropriate hurdles to qualify a debtor for such extraordinary relief as is afforded by bankruptcy and a set of clear and appropriate sanctions against behavior that would abuse the system designed to provide equitable resolution of financial catastrophes. Without social stigma, without economic or legal consequence, and, increasingly, without a shared set of societal values that reinforce debt repayment, we can expect continued growth in unnecessary bankruptcy losses.

Mr. **GEKAS.** The Chair notes the attendance, now of the gentleman from Massachusetts, Mr. Delahunt.

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Now we'll return to Mr. McDonnell.

STATEMENT OF BRIAN L. McDONNELL, PRESIDENT AND CEO, NAVY FEDERAL CREDIT UNION, REPRESENTING THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. **MCDONNELL.** Good morning, Mr. Chairman and members and the committee.

My name is Brian McDonnell. I'm the President and CEO of Navy Federal Credit Union. I'm here today on behalf of my credit union and the National Association of Federal Credit Unions to express our support for reform of the Nation's bankruptcy system.

Navy Federal is the Nation's largest credit union. We serve nearly 1.7 million military and civilian employees of the Department of the Navy and their families.

As with all credit unions, we are a not-for-profit cooperative governed by a volunteer and unpaid Board of Directors who are elected by our member-owners. Credit union represent a significant cross-section of all of Americas financially responsible consumers.

Unfortunately, a small, but growing number of consumers are not financially responsible, and some abuse the system at a very significant cost to everyone. We feel very strongly that bankruptcy reform is needed to encourage financial responsibility for debtors, and for those creditors who would gouge or mislead consumers.

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We are not opposed to bankruptcy relief for persons who have a bona fide need. Our concern is with those consumers who use bankruptcy as a financial planning tool, and those who turn to bankruptcy as the easy way out.

Nationally, consumer bankruptcies have spiraled upward. Navy Federal has also experienced a significant upward trend. In 1997, Navy Federal's charge-offs to bankrupt members totalled $26 million. That's up from $1.5 million 15

years ago shortly after the passage of the Bankruptcy Reform Act of 1978. Our total loss ratio increased 129 percent during the past 15 years. The nonbankruptcy portion increased 35 percent, while the bankruptcy loss ratio increased a staggering 264 percent.

The cost of bankruptcy at Navy Federal must be borne by our financially-responsible members. In 1997, if we had experienced no bankruptcy losses, our consumer loan rates and our 12.5 percent no-annual fee VISA credit card rate could have been significantly reduced. But, of particular concern is that bankruptcy is also anti-consumer in nature, because responsible consumers pay the cost for the few who elect bankruptcy.

Many are encouraged by attorney advertising. It especially hurts young people, because once bankrupt, they have difficulty obtaining credit at reasonable rates from responsible financial institutions. The average age of our bankrupt member last year was 32. Credit unions, traditionally, pay higher rates on savings and charge lower rates on loans than banks. Because of lower operating margins, we are hit harder by escalating bankruptcy costs. A natural reaction is to increase loan rates, but that is not what credit unions do. We try to keep our interest rates low—as low as we can for the benefit of all of our members.

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Credit Unions have traditionally relied on member education and counselling to encourage financial responsibility. At Navy Federal, our employees assist with checkbook balancing and family budgeting. They advise members on the merits of savings and the consequences of heavy debt loads. We write newsletter articles and provide members with brochures to assist in making responsible financial decisions. In addition, we place a high priority on sound underwriting practices to reach our limited resource members who truly need credit. We scrutinize all applications, and if an applicant's circumstances do not support the requested amount, we counter with a lower debt limit offer that we believe that the applicant would be able to repay.

We believe we do a good job of member education and loan underwriting, but we take it one step further. To illustrate, we have a young family, both parents in the military who scheduled an appointment to seek legal advice for bankruptcy. Before the meeting, they received our flyer entitled "Bankruptcy: A Problem We All Share." As a result, they contacted our budgetary counselling staff to see if there was an alternative to bankruptcy. We explained our debt management program. They agreed to participate. We negotiated with other creditors for debt adjustments, and lowered Navy Federal's payments. Except for essential family living expenses, they send all of their income to Navy Federal. We actually pay their monthly bills and make their loan payments to other lenders while we provide ongoing financial counselling to the family. In a few months, we will begin to return the financial responsibility back to this family.

In 1997, almost 2,000 families were assisted by our program. This service is free to any member, even though the direct annual cost to us is, approximately, $700,000. I believe this program is a good example of creditor responsibility.

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Now, despite all of our efforts, we still need bankruptcy reform to encourage financial responsibility. I believe the needs-based feature of H.R. 3150 is a positive step. I also believe the Debtors Bill of Rights, creditor protections, and the test-training program will promote financial responsibility. We are also very pleased that H.R. 3150 retains provisions of the current code that permit debtors to reaffirm their debts with their credit unions rather than be forced to go elsewhere and pay exorbitant rates for loans and other financial services.

Mr. Chairman, I have included in my written testimony, a detailed proposal to improve the bankruptcy system. I hope you will consider our proposals for mandatory debtor education, reasonable uniform exemptions, and in establishing a National Advisory Council to monitor and evaluate bankruptcy. I applaud your efforts and those of other committee members to reform the bankruptcy system, and I appreciate the opportunity to appear before you today.

[The prepared statement of Brian L. McDonnell follows:]

PREPARED STATEMENT OF BRIAN L. MCDONNELL, PRESIDENT AND CEO, NAVY FEDERAL CREDIT UNION, REPRESENTING THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

INTRODUCTION

The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of more than 1,060 federal credit unions—financial cooperatives from across the nation—that collectively hold approximately 70 percent of total federal credit union assets; NAFCU represents the interests of approximately 25 million individual credit union members. NAFCU and the entire credit union community appreciates this opportunity to participate in the discussion regarding the need for reform of the nation's bankruptcy system.

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NATURE OF CREDIT UNIONS

Historically, credit unions have served a unique function in the delivery of financial services to people of modest means. Every credit union is, by statute and practice, a cooperative association organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." [12 USC 1752(1)] While more than 60 years have passed since the Federal Credit Union Act was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as they were when Congress first authorized the establishment of federal credit unions:

First, credit unions remain totally committed to providing their members with efficient, low-cost personal service.

Second, credit unions continue to emphasize traditional cooperative values, such as democracy and volunteerism.

As owners of not-for-profit, cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—regardless of the amount they have on account at the credit union. These singular rights extend all the way from making basic operating decisions to electing the board of directors. Unlike banks and thrifts, federal credit union directors, motivated by an altruistic desire to be of service to others, serve without remuneration—a fact that epitomizes the true "volunteer spirit" which permeates the credit union community.

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Credit unions play an important role in the financial lives of more than 70 million Americans from all walks of life who have chosen the convenient and low-cost financial services that only credit unions can provide. As the package of services offered by various types of financial institutions becomes more and more homogenized, the emphasis shifts from the type of service offered to the quality and cost of service provided. Historically, credit unions have been second to none in providing their members with quality personalized service at the lowest possible cost. According to an annual survey conducted by the American Banker newspaper, 1997 was the thirteenth consecutive year in which credit unions have rated higher than all other financial institutions in overall service quality and this trend shows no sign of change.

NEED FOR BANKRUPTCY REFORM

Navy Federal Credit Union (Navy Federal) is the nation's largest credit union. Navy Federal serves civilian and military employees of the U.S. Department of the Navy and their families, serving almost 1.7 million members around the world through 84 branch offices, 183 proprietary ATMs, access to world-wide ATM networks, and "24 hour/365 day-a-year" telephone and internet service from its Vienna, Virginia headquarters and operations center. As with all

federal credit unions, Navy Federal is a not-for-profit cooperative, governed by a volunteer and unpaid board of directors who are elected by the credit union's member-owners. Navy Federal operates in the cooperative credit union spirit of "people helping people."

Unfortunately, a small but growing number of consumers are not financially responsible and abuse the bankruptcy system at a high cost to the consumers and the national economy. The credit union community feels strongly that bankruptcy reform is needed to encourage financial responsibility for debtors and for those creditors who would mislead or take advantage of consumers. The bankruptcy reform issue is not an issue of balancing the pursuits of debtors with the interests of creditors. It is simply an issue of financial responsibility versus financial irresponsibility.

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The credit union community does not oppose bankruptcy relief for persons who have a bona fide need—those who have encountered extraordinary circumstances in life. Instead, the concern is with those consumers who use bankruptcy as a financial planning tool and those who turn to bankruptcy as the "easy way out."

For example, Navy Federal has a young member named Ruth who was living at home with her family. She incurred a few debts, one to Navy Federal, with her father as a cosigner. She decided to strike out on her own and moved to California where she ran into financial difficulty and was advised by her friends and an attorney to file for Chapter 7 bankruptcy relief. Navy Federal contacted the unsuspecting father who persuaded Ruth to consult the local Consumer Credit Counseling Service. After initial consultations with the counselors, Ruth withdrew her bankruptcy petition and repaid her debts through the counseling service's budget program. Because of the aid provided by Navy Federal, Ruth was able to avert ruining her credit rating and is able to obtain credit today.

COSTS OF BANKRUPTCY

Nationally, consumer bankruptcies have spiraled upward. Credit unions throughout the country have experienced a similar dramatic increase in consumer bankruptcy filings and losses in recent years (as indicated in Appendix A, Chart I). According to statistics compiled by NAFCU's Research Division, approximately $1.13 billion in loans were subject to bankruptcy at federally insured credit unions in 1997. That number is nearly double the amount subject to bankruptcy just three years earlier (Appendix A, Chart II). Over those three years the number of non-business bankruptcy filings grew at an average rate of 17 percent a year (Appendix A, Chart III). These numbers indicate a dangerous trend that must be addressed by Congressional action.

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In recent years, Navy Federal has experienced a significant increase in members seeking relief through the bankruptcy courts. Each month, Navy Federal charges off $2 to $3 million in loans to bankrupt members. In 1997, Navy Federal's charge-offs to bankrupt members totaled $26 million—a figure up from $1.5 million 15 years ago, shortly after passage of the *Bankruptcy Reform Act of 1978*.

As with other credit unions, the costs of bankruptcy at Navy Federal must be borne by the financially responsible members of the credit union. In 1997, if Navy Federal had experienced no bankruptcy losses, consumer loan rates could have been reduced by more than one-half of 1 percentage point. Navy Federal's VISA Classic credit card rate, which is currently 12.5 percent with no annual fee, could have been reduced 1.3 percentage points. It is important to understand that bankruptcy is anti-consumer in nature because responsible consumers pay the debts of the few who elect bankruptcy as a financial planning tool—encouraged by the advertising of unscrupulous attorneys or financial advisors. The seemingly quick "fix" of filing for bankruptcy is also harming young consumers as more and more are choosing it as an alternative. Once a young person chooses bankruptcy, he or she often has difficulty obtaining credit at reasonable rates from responsible financial institutions.

CREDIT UNION RESPONSE TO BANKRUPTCY

Most credit unions have lower operating margins than other types of lenders. Typically, credit unions pay higher rates on savings and charge lower rates on loans than other financial institutions. For example, Navy Federal currently pays 5 percent on its most popular share savings certificates, 7 percent on IRA share certificates, and charges 7.5 percent on the most popular auto loan. Because of these smaller margins, credit unions are hit harder than other financial institutions by escalating bankruptcy costs. A natural reaction for some institutions is to increase interest rates, but that is not what credit unions do. Credit unions keep interest rates as low as possible for the benefit of their members. At Navy Federal, the total loss ratio increased 129 percent over the last 15 years. But what is particularly significant is that while the non-bankruptcy loss ratio increased 35 percent, the bankruptcy loss ratio increased at a pace 7.5 times that rate: *a staggering 264 percent*.

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Credit unions do much to promote financial responsibility among their members. Because credit union members pool their resources for the mutual benefit of all members, they have traditionally relied heavily on member education and individual counseling to encourage and promote financial responsibility. At Navy Federal, employees are trained in financial counseling. They assist with check book balancing and family budgeting. They advise members on the merits of saving and the consequences of heavy debt loads. Newsletter articles are published and brochures are provided for members to assist in making responsible financial decisions. Included in Appendix B are three examples of the brochures that Navy Federal publishes to assist its members with debt management and budgetary counseling. As one can see from the attached brochure, "Dollar Discipline Works!," Navy Federal attempts to educate all of its members on issues such as how to save money, how to borrow effectively and how to compute a monthly budget. All of these concepts are vital to an individuals ability to plan for a safe future.

In addition to member education and counseling activities, Navy Federal, like most credit unions, places an extremely high priority on sound underwriting practices. Navy Federal is continually upgrading and refining its underwriting techniques and tools. Automated tools are used in conjunction with traditional loan officer evaluations for all loans. Navy Federal attempts to reach those members with limited financial resources who truly need credit, by meticulously scrutinizing all applications. If an applicant's circumstances do not support the requested amount, Navy Federal may offer to assist by countering with a lower debt limit offer that the member may be able to repay.

Again, like most credit unions, Navy Federal does an excellent job of member education and loan underwriting, but at Navy Federal this is taken one step further. To illustrate, a young husband and wife, both in the military, and Navy Federal members, recently scheduled an appointment to seek legal advice for bankruptcy. Before the meeting, they received in their monthly statement from Navy Federal, a flier entitled "Bankruptcy, A Problem We All Share." As a result of reading the flier, they contacted Navy Federal's Budgetary Counseling Staff to see if there was an alternative to bankruptcy. We explained our intensive Budgetary Counseling and Debt Management Program and asked if the family wanted to participate. They agreed. We negotiated with other creditors for debt adjustments and lowered Navy Federal's payments. Except for essential family living expenses, they send all their income to Navy Federal. We actually pay their monthly bills and make their loan payments to other lenders. We are counseling this family on the wise use of credit and the responsible use of their financial resources. In a few months we will begin to return financial responsibility back to this family as they are, in fact learning to become financially responsible consumers. In 1997, almost 2,000 families of Navy Federal were assisted by this program.

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Members are charged nothing for this service even though the annual direct labor and supporting cost for this intensive Budgetary Counseling and Debt Management Program is approximately $700,000 excluding debt and interest adjustments. Often, interest is reduced or waived to enable members to continue making loan payments. Currently, over $3.2 million of Navy Federal's consumer loan and credit card portfolio accrues zero interest at an annual loss to the credit union of an additional $300,000. However, assisting members to become financially responsible is a sound investment of credit union resources; Navy Federal believes it is also a good example of creditor responsibility.

REFORM EFFORTS: CREDIT UNION PERSPECTIVE

Because of the rising number of personal bankruptcy filings, the credit union community believes that legislative action is necessary to improve the current bankruptcy system. To support Congress in that effort NAFCU established an ad hoc Bankruptcy Committee. Only after extensive study, and bolstered with the input of a nationwide survey of credit unions, did NAFCU's ad hoc Bankruptcy Committee approve a formal "Proposal to Improve the Bankruptcy System." The product of a genuine effort to improve our nation's bankruptcy laws and procedures. A copy of this proposal is included as Appendix C).

To better understand how the nation's credit unions are affected by bankruptcy, NAFCU's ad hoc Bankruptcy Committee surveyed over 1,050 federally chartered credit unions (Appendix D for NAFCU Member Survey Responses). Approximately 97 percent of the respondents support a bankruptcy system that is needs-based. This would help to increase debtor accountability, create a fairer bankruptcy system, and more fairly distribute payments among all creditors. Debtor education was also viewed as critically important issue. Much like Navy Federal, most credit unions attempt to provide the best possible education for their members. Of those surveyed 84 percent support a requirement that would require debtors to participate in credit counseling before filing bankruptcy. Because of the current trends in bankruptcy filings and the views of all credit union members Navy Federal is pleased that attempts are being made to "reform" the current system. Reform is needed immediately as this problem grows and becomes more serious and widespread everyday.

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As reflected in NAFCU's proposal, credit unions throughout the country advocate meaningful reform of the bankruptcy system. NAFCU's proposal include recommendations that:

The Bankruptcy Code should require that debtors who are able to pay a portion of their debts file a repayment plan under Chapter 13;

The Code should establish uniform rules and procedures for processing creditors' claims and payments;

The Code should establish uniform federal exemptions;

Debtors should be required to complete a basic financial education course prior to receiving discharge;

A debtor should be required to notify secured creditors, within ten days of filing bankruptcy, whether the debtor intends to surrender, redeem, or reaffirm the collateral; and,

For creditors seeking to recover collateral, the automatic stay should expire at the end of the notification period.

NAFCU also recommends establishing a Bankruptcy Advisory Council, which includes debtor and creditor representatives. The council should be charged with studying bankruptcy and bankruptcy reform. This council could be established under the auspices of the U.S. Department of Justice. Alternatively, the Federal Reserve Board's existing Consumer Advisory Council should be required to submit an annual report to Congress on bankruptcy and bankruptcy reform.

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REFORM EFFORTS: CONGRESSIONAL ACTION

Despite all of the efforts to educate, to make sound loans, and to assist those in trouble, bankruptcy reform is needed *and is needed now* to encourage financial responsibility. The needs-based approach of H.R. 3150, the *Bankruptcy Reform Act of 1998* introduced by Representatives George Gekas (R-Pennsylvania) and Jim Moran (D-Virginia), is a positive step towards helping to ensure more responsibility. H.R. 3150 would make a number of changes to U.S.

bankruptcy law in an effort to prevent fraudulent bankruptcies and increase the likelihood that bankruptcy filers will repay their debts. NAFCU supports H.R. 3150.

NAFCU is pleased that H.R. 3150 stresses a needs-based system of bankruptcy. This would help in determining the correct amount of financial relief necessary. The *Debtor's Bill of Rights* provision should provide protection for debtors from "bankruptcy mills"—law firms and other groups that steer consumers to bankruptcy. Other provisions of the *Bankruptcy Reform Act of 1998* that will aid bankruptcy reform include: the creation of a consumer education program, debtor notification, and developing a national database.

CONCLUSION

Even before the National Bankruptcy Commission released its findings to Congress in October 1997, the need for overhaul of the nation's troubled bankruptcy system was evident. As bankruptcy filings increase, the burden on financial institutions also increases—a burden that ultimately is shouldered by the American consumer. We recognize the need for reform and are grateful that Congress is focused on the problem and is as determined as we to establish equitable reforms.

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On behalf of NAFCU, thank you for considering the credit union perspective. We applaud your efforts and those of the Committee and hope to continue to work with you to resolve these and other challenging issues.

APPENDIX A—BANKRUPTCY STATISTICS

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APPENDIX B—NAVY FEDERAL CREDIT UNION COUNSELING BROCHURES

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BUDGETARY COUNSELING—NAVY FEDERAL CREDIT UNION

Budgetary Counseling

Navy Federal Credit Union offers Budgetary Counseling *at no charge* to help answer your personal money management questions or problems and help you to be an informed consumer in today's marketplace. You do not need to be in debt to Navy Federal to take advantage of our Budgetary Counseling service.

A variety of ways to assist you

Productive Counseling—We can help you recognize, set, and achieve financial goals by providing information. For example, a member might want to save for a down payment on a car, but can't seem to do it. We can provide information on how to set up a budget and stick to it.

Preventive Counseling—Navy Federal can help you to appraise your financial status realistically and develop money management skills to avoid or solve financial problems through person-to-person counseling over the phone. For example, a two-income couple with a baby on the way realizes that their financial situation is going to change drastically. Budgetary Counseling can help them prepare for the change by developing a savings plan (to draw upon while the wife is on maternity leave), as well as a new budget that includes items for the new family member (food, formula, child care, etc.).

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Remedial Counseling—We can help you deal successfully with a financial crisis through a Debt Management Program. For example, a recently divorced man finds himself responsible for all consumer debts incurred by the couple while married, plus the added expense of alimony and child support. Suddenly he is over his head in debt. If he has sufficient disposable income, he can voluntarily enter the Debt Management Program. Navy Federal contacts his creditors and requests that they accept reduced regular payments until the member is financially stable and able to resume handling his own obligations. The member sends his monthly disposable income to Navy Federal in time for Navy Federal to distribute it among his creditors. (NOTE: This is not a bill-paying service; only members who are unable to meet their contractual obligations to their creditors are eligible for enrollment.)

Where to start

For Productive Counseling—write for a copy of Navy Federal's *Dollar Discipline Works!* brochure, or pick up a copy at any Member Service Center (MSC).

For Preventive or Remedial Counseling—call or write for a Budgetary Counseling form, or pick one up at any Navy Federal MSC. Complete the form, retain a copy for yourself, and submit it to Navy Federal headquarters. A Budgetary Counselor will review it and telephone you at home or work to discuss your situation.

Call
Toll-free: 1-800-336-3767

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Locally in metro Wash., DC: 703-255-8062
TDD for the Hearing Impaired: 703-255-8878
Hours are 8:00am to 4:30pm, Eastern time, Mon.-Fri.

Fax
703-206-4107

Write

Budgetary Counseling
Navy Federal Credit Union
PO Box 3000
Merrifield VA 22119-3000

Confidential service

Budgetary Counseling is purely voluntary and confidential. There is no stigma connected with requesting this help, and no report is made of the request or that counseling has been given. However, if a Debt Management Program is established, credit reporting agencies may he advised by creditors in order to make other existing and potential creditors aware of the member's voluntary enrollment and to maintain the integrity of the program.

The benefits

Freedom from financial worry, as you develop money management skills and find that *you* are in control of your money, not the other way around!

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Check your financial health

Table 1

The results

Table 2

DEBT MANAGEMENT PROGRAM—NAVY FEDERAL CREDIT UNION

Debt Management Program (DMP)

Navy Federal has been helping its members deal successfully with their financial problems through the Debt Management Program (DMP) for over 20 years. Our goal is to help our members help themselves. Through the DMP our members can successfully gain control of their debts. They also develop the personal money management skills needed and leave the program as informed consumers in today's marketplace.

Your budgetary counselor

Your Navy Federal Credit Union personal budgetary counselor is **XXXXXXX**.

Your counselor is responsible for handling your DMP; he/she acts as a go-between, between you and your creditors. If creditors contact you asking for money, refer them to your counselor by name and give them this telephone number 703-**XXXXX**.

(Please do not give out the 800 number; it is for NFCU members only.)

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If you have any questions about your DMP or Navy Federal accounts, please talk it over with your assigned counselor, since he/she is familiar with your case.

Contacting your counselor

The phone number above is your counselor's direct line. You can also use the toll-free number shown on the reverse of your counselor's business card. If your counselor is not available, his/her automated phone answering system will be turned on. The system is used only when counselors are unavailable. The counselors do review their messages every 30/45 minutes (in the case of absent counselors, another counselor will review phone messages), and do make every effort to return calls and inquiries as soon as possible. However, hectic work schedules sometimes make a same-day reply not possible.

DMP money due policy

Money for the DMP in the amount of **XXXXX** is due in your share savings account by the **XXXXX** of each month. On that date, your counselor reviews your share savings account; if the money is available in your share savings account, your counselor requests checks for your creditors and mails them. If money will not be available in your account by the due date, be sure to call your counselor and explain why—so your counselor can, in turn, advise your creditors why they will not be receiving the agreed-upon payment.

What your creditors are told

Your counselor sends out a proposal letter to each of your creditors asking them to work with us and to accept a reduced payment from you, our DMP client. Navy Federal also asks each creditor to reduce the interest rate, waive late fees and/or bring the account up to current status. The decision to do this is totally up to each individual creditor. Navy Federal's job is to develop a workable program for you and to act as a go-between. The creditor makes it a reality by agreeing to work with NFCU. *Creditors are under no obligation to reduce interest rates, waive late fees, or report an account current*. You, Navy Federal, and the creditors must all work together to make the program successful. Credit card creditors will usually ask that you return your credit cards to them or sign an affidavit stating the cards have been lost or destroyed. Do not send your cut-up credit cards to your personal budgetary counselor at Navy Federal.

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Emergencies*

If an emergency occurs and it is going to affect the amount of money you have available for the DMP, contact your counselor as soon as possible. In an emergency, money used for the DMP often must be used for the emergency itself. *It is very important that you tell your counselor about the emergency so he/she can:*

Give informed answers to your creditors about your emergency situation and when they can expect payments to start up again;

Keep your DMP intact.

*An emergency can be considered anything that disrupts your household spending plan such as car repairs, illness/hospital bills, death in the family, lost job, etc.

Member service center procedures

If you attempt to withdraw or transfer money from your share savings account at a member service center, a DMP restriction will appear on the teller's screen requiring authorization for the withdrawal from either your counselor or the member service center supervisor. The purpose of the restriction is to keep your DMP money available in your share savings account for your counselor to withdraw to process checks for your creditors. To expedite the savings withdrawal process, you may call your counselor ahead of time and tell him/her you plan to make the savings withdrawal. This way, your counselor will be prepared for the phone call. You are welcome to withdraw any excess money in your savings account, but if you are trying to withdraw money used for the DMP, your withdrawal request will be denied.

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ATMs and Touch-Tone Teller access

A Navy Federal CUCARD* for use in ATMs can be used for all transactions *except withdrawing or transferring money from your share savings account.* Your share savings account is frozen until you withdraw from the DMP. If

you need to transfer money from your savings to other accounts, call your counselor. Other transfers or inquiries can be handled by NFCU's Inquiry Section (1-800-914-9494) or via NFCU's toll-free Touch-Tone Teller service (1-800-842-6328). To conduct credit union business over the phone 24 hours a day through the Touch-Tone Teller service, you will need a Personal Identification Number (PIN), a four-digit code. To get a CUCARD and PIN, simply complete a *CUCARD and PIN Application*. Applications are available at any Navy Federal member service center or by mail from NFCU, PO Box 3000, Merrifield VA 22119-3000.

Creditor status

From time to time, it's a good idea to check on the repayment status of all your creditors. You can help your counselor keep track of the DMP payments by reviewing your monthly statements from your creditors. Make sure your DMP payments are being credited to your account.

Applying for loans

Current and past debt management clients can apply for a Navy Federal loan (either by mail, at a member service center, or by using the toll-tree number). You should discuss the loan situation with your counselor and get his/her recommendation or advice before applying. Your loan applications are treated just like any other Navy Federal loan applications with one exception: The loan officer will ask your counselor for a recommendation based on how well you maintained your DMP—such as whether your money was received in a timely manner each and every month, whether or not you kept your counselor informed of emergency situations, etc. The bottom line is whether you kept your end of the program running smoothly.

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Like any loan request at Navy Federal, the criteria of character, capacity, and collateral are used in the loan decision process.

Character—Does your credit reputation indicate that you will honor your financial obligations? Do you live within your means? The loan officer will also look for signs of stability: how long you have lived at your current address and your length of employment.

Capacity—Can you repay the debt? Can you meet your monthly loan payments as well as your other current obligations? The loan officer will be looking at your earning power (present and future income) and your current commitments.

Collateral—(when required) Is the collateral sufficient to secure the loan? Is Navy Federal fully protected if you fail to repay the loan?

Credit Renewer Visa

Navy Federal offers a Credit Renewer Visa program designed to help members with prior credit problems reestablish a good credit rating. This special Visa Classic card is issued for a three-year trial period and must be secured by an amount in the cardholder's share savings account equal to 150% of the credit line. For example, a $500 approved credit limit requires a pledge of $750 in shares. The amount of credit granted is determined by the regular criteria of the Credit Committee and by the amount of shares pledged. The pledged shares must remain in savings for the duration of the trial period; however, they continue to earn dividends. Upon successful completion of the trial period, the account can be converted to a regular Visa Classic. For more information, pick up or request the Visa Credit Card Services brochure. To apply, call or complete a Visa Credit Card Application.

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Withdrawing from the program

If you decide you want to take back responsibility for your own financial situation, you may do so at any time. Contact your counselor about your decision to withdraw from the DMP. Notifying your counselor is especially important to maintain the DMP's credibility with creditors we deal with. Once you have withdrawn from the program, your creditors will receive letters telling them that from now on you will be responsible for the monthly payments.

Involuntary withdrawal from the program

Members who do not get the required money into their savings accounts by the agreed day for a total of three consecutive months are dropped from the program if they do not contact their counselor with an explanation as to why the funds are not available. Once members are dropped from the program, their creditors receive letters notifying them that the member is responsible for the monthly payments.

Referrals

When you leave the program, your counselor will be glad to furnish you with a referral letter, if requested. The letter will contain the following information: when the program started and ended; and how the program was maintained, either "satisfactory" or "not satisfactory."

Late notices and phone calls

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Even after you have been enrolled for some time in the DMP, you still may receive bills and/or late notices through the mail from your creditors. Usually, these notices are computer-generated, meaning they are automatically sent out if the payment is not received on time or if it was not for the full payment amount. Once the total amount ot DMP money is deposited into your share savings, your counselor requests checks and sends them to your creditors regardless of the due dates. Your counselor is responsible for sending out several hundred checks per month. Because of this, it is not possible to make multiple disbursements from your account to meet the differing due dates of each of your creditors. So, inevitably some payments will not reach your creditors on their due date. Another reason for the late notices could be that the payments received by your creditors are not for the full amount; they are partial amounts (part payments). Even though creditors have agreed to accept a partial payment from our DMP clients, the notices may still be sent out automatically. The only time you need to consult your counselor about these letters/notices is when they are hand-signed by an individual. You may also get computer-generated phone messages. If someone (other than a recording) calls asking about payments, refer them to your counselor by name.

Once a member, *always* a member.

APPENDIX C—NAFCU'S PROPOSAL TO IMPROVE THE BANKRUPTCY SYSTEM

Credit unions are truly unique in the financial services industry. They are cooperatives, organized to ensure that each member-owner has the opportunity for an equal voice in their operation. They are volunteer-led organizations established not to return profits to a limited number of shareholders, but to pool the financial resources of their member-owners in order to provide other member-owners with access to prudent credit programs and other financial services. Because of their not-for-profit status and because of their cooperative organization, the institutional voice of credit unions is the voice of their member-owners. The National Association of Federal Credit Unions (NAFCU) represents federally-chartered credit unions comprised of 23.3 million credit union member-owner-consumers. NAFCU believes the voice of credit unions is a strong voice for all consumers.

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NAFCU PERSPECTIVES ON BANKRUPTCY

NAFCU believes it is imperative that our nation's public policy, as implemented through bankruptcy statutes, supports a strong sense of responsibility and accountability for both debtors and creditors. Some commentators suggest that some creditors entice consumers into financial difficulty with offers of easy and over-abundant credit. Conversely, others criticize debtors for taking advantage of the system by willfully or irresponsibly over-extending themselves financially and then legally absolving their obligations through bankruptcy. Bankruptcies have attained record high levels during a time when the U.S. economy has performed very favorably. Accordingly, NAFCU seeks to strengthen the nation's bankruptcy statutes to preserve and promote financial responsibility among its member credit unions and their members. If bankruptcy laws are not amended to increase the responsibility and accountability of both debtors and creditors, consumers will be adversely affected by the resulting increased credit costs. Without question, some consumers with significant financial problems file bankruptcy for good reasons. However, more and more consumers file bankruptcy without ever considering possible alternatives, thereby hurting both those with a legitimate need to file and other consumers who must ultimately pay the bill, especially credit union members.

An article in the January 1997 *Federal Reserve Bulletin*, reporting on the Fed's most recent Survey of Consumer Finances, highlights three noteworthy findings:

Between the 1992 and the 1995 surveys, both median family income and median family net worth rose in constant dollars.

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The ownership and the amount of holdings of publicly traded stock by families expanded greatly over this period.

The survey provided little evidence of a serious rise in debt payment problems between 1992 and 1995.

In his February 26, 1997 statement before the Senate Committee on Banking, Housing and Urban Affairs, Federal Reserve Board Chairman Alan Greenspan reported, "The performance of the U.S. economy over the past year has been quite favorable." The Fed, in its Monetary Policy Report to Congress submitted on July 22, 1997, stated, "The economy continued to perform exceptionally well in the first half of 1997."

Notwithstanding the Fed's very favorable evaluation of the economy, the American Bankruptcy Institute, in a press release dated August 15, 1997, reported that bankruptcy filings across the country continued to climb during the second quarter of 1997, reaching 367,168. This was the sixth successive quarter filings have increased, jumping nearly 10 percent over the previous quarter and 24 percent over a year earlier. Consumer filings in the second quarter of 1997 continued to drive the surge and reached an all-time high of 353,177, comprising 96.2 percent of all filings. Consumer filings in 1989 represented just 90.7 percent of all filings. More than 1.1 million consumers filed for protection of the bankruptcy courts during all of 1996, compared with 780,000 two years earlier and 616,000 in 1989.

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The pattern of bankruptcy filings by members of credit unions is similar (although the year-toyear changes generally are not as pronounced) to the overall upward trend in the number of filings by all consumers (see chart). Filings by credit union members in 1996 were up 35 percent from the previous year. Despite the sharp increase in 1996, the overall increase among all credit union members filing bankruptcy since 1989 at 49 percent has been lower than for the general population. Filings by all consumers in 1996 were 83 percent above 1989. For federally-insured credit unions, the amount of loans subject to bankruptcy in December 1996 was 0.46 percent of total loan balances, compared with 0.42 percent in December 1995 and 0.33 percent in December 1994. Bankruptcy for all consumers and among credit union members is rising at alarming rates, despite a sound and favorably performing economy.

The reasons for these high levels of bankruptcy in good economic times are very complex. On September 12, 1996, Governor Lawrence B. Lindsey of the Federal Reserve Board addressed this issue before the House Committee on

Banking and Financial Services, as follows:

While rising levels of consumer debt may be contributing to the climb in bankruptcies, bankruptcy law may also be contributing to rising debt levels. Several factors are said to be contributing to higher rates of personal bankruptcy, including greater social acceptability of the practice, changes in law that have made bankruptcy less onerous for individuals, and increased advertising by bankruptcy attorneys. To the extent that bankruptcy is perceived by consumers as an easier option, the demand for credit, and particularly the willingness to take on high levels of credit, is enhanced. With the consequences of bankruptcy reduced, individuals, other things equal, may be more willing to borrow than would otherwise be the case. One may not wish to foreclose the possibility of renewed credit access to those who have been forced by uncontrollable circumstances to seek the protection of bankruptcy, but it should be recognized- that undue generosity on this score only encourages greater use of the bankruptcy remedy and consequent chargeoffs.

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Govemor Lindsey's remarks are borne out by numerous media stories. In an article about bankruptcy, a headline on page 85 of the August 1993 issue of Money magazine proclaimed, "The court let them walk away from over $32,000 in debts even though they might have been able to pay their creditors in less than three years." Additionally, the article named several celebrities who were able to maintain multi-million dollar homes while in bankruptcy.

A review of the 1997 Northern Virginia Bell Atlantic Yellow Page advertisements for lawyers reveals a variety of proclamations concerning bankruptcy, including:

"The Bankruptcy Law allows you to discharge most credit card purchases, medical expenses and other outstanding debts."

"Solve money troubles with BANKRUPTCY"

"!!!EMERGENCY BANKRUPTCY!!! QUICK FILING LOW FEES"

"Filing Bankruptcy will allow you a fresh start and remember . . . Everyone needs a helping hand sometimes."

The National Divorce & Bankruptcy Center's world wide web page leads the reader to believe the bankruptcy process is easy and painless. It announces, "Every Citizen's right to know and use the law —without an attorney—is fundamental to American Democracy." In response to the question, "Can I get 'new' credit after bankruptcy?" it answers, "YES! Properly explained, bankruptcy may have little or no effect upon future credit. The stigma once attached to those that file bankruptcy is all but gone, due in large part to the widely reported bankruptcy filings of celebrities, and even some city and county governments."

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The following are actual, real life, examples of credit union members who filed for protection under current bankruptcy statutes:

A young enlisted marine in North Carolina went to an attorney with only $3,000 in total debts. The attorney charged him approximately $1,000 to file a Chapter 13 bankruptcy—a proceeding which was unnecessary based on the low level of debt and the marine's repayment ability.

A credit union member in California, recently separated from her husband, went to an attorney who filed paperwork for a Chapter 13 bankruptcy plan to pay less than $2,500 in debt. For the next 36 months, she will pay $65 per month to her creditors. Attorney fees in this area of California usually range from $600 to $900 or more for a simple Chapter 13 bankruptcy filing.

A young woman living in California had her father on the East Coast co-sign a loan for $3,000. She then encountered some financial difficulties. recommended that she file for bankruptcy. Without advising her father, she went to an attorney and filed Chapter 7 bankruptcy. When creditors contacted the unsuspecting father about the situation, he immediately contacted the daughter and persuaded her to consult with Consumer Credit Counseling Services (CCCS). After initial discussions with CCCS, the young woman withdrew her bankruptcy, and paid her creditors through a CCCS budget program.

We believe these anecdotes are representative of hundreds of other credit union members and thousands of other consumers in similar circumstances. A recent study conducted by The Credit Research Center at Georgetown University indicated that 25 percent of the individuals discharged under Chapter 7 could repay, from regular income, over 30 percent of their nonhousing debt over a five-year period. On June 10, 1997 *USA Today* reported, "Americans are going broke in record numbers. Despite the longest peacetime economic expansion this century, more than 1 million Americans filed for personal bankruptcy last year, agreeing either to restructure their debts and repay them or, more likely, simply walk away and start anew." A bankruptcy system that permits or inadvertently encourages its citizens to simply walk away from their obligations shifts the economic burdens of those actions to other, more responsible members of society. Such a system would further alienate marginal borrowers from the conventional lending of regulated financial institutions as more of those lenders would be unwilling to accept the risk of increased bankruptcy losses. Additionally, persons of small means and limited resources who use costly fringe credit sources would likely be pushed further away from the mainstream of the consumer financial services industry.

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Credit unions, as member-owned financial service organizations, created with the philosophy of people helping people, recognize the need for functional and efficient bankruptcy procedures that properly balance financial responsibility with relief provisions for debtors having unusual or extraordinary circumstances. Unfortunately, relief for any member, via the bankruptcy system, represents a cost that must be borne by all other members through increased interest rates on loans and reduced dividend rates on savings. Under the current bankruptcy system, the financially-responsible majority must pay the costs of the irresponsible actions of a small but increasing number of credit union members. Additionally, administrative expenses involving attorney's fees and staff time associated with burdensome bankruptcy procedures significantly increase the total cost that must be passed on to those financially-responsible members of credit unions.

NAFCU believes the nation's bankruptcy policy should be closely aligned with the credit union philosophy of people helping people in a responsible fashion. Credit unions were founded on the belief that people in similar circumstances joined together to provide financial services would benefit the entire group. The joint benefit and the costs of providing that benefit was to be shared by the group. Therefore, credit unions focus on educational programs and other forms of assistance to promote financial responsibility among their members.

On February 26, 1997, National Credit Union Administration Board Chairman Norman D'Amours testified before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services about credit union activities and services. Referring to the nation's largest credit union, he said "It serves people in the military, several of whom are on food stamps. . . . It provides services, counseling services, free of charge. . . . [Members] get counseling as to how to do the basic things that a lot of us have learned to do over the years because of our backgrounds and educations . . . " Across America, thousands of small and large credit unions alike promote financial education and assistance programs. They foster financial responsibility among their members while pursuing prudent lending policies. We believe these activities embodied in the credit union philosophy of people helping people contribute to the lower incidence of bankruptcy loss among credit union members than for consumers generally as indicated by the year-end 1996 net charge-offs for credit unions at 0.47 percent of loans, compared with 2.29 percent for commercial banks.

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Bankruptcy filings are rapidly rising while the economy is prospering. The costs of bankruptcy losses are borne by

all consumers through increased loan rates and stricter lending standards. In order to combat this crisis, significant bankruptcy reform is needed. NAFCU supports reform of the Bankruptcy Code which balances the needs of both creditors and debtors.

EVALUATION OF NBRC PROPOSALS

Pursuant to the Bankruptcy Reform Act of 1994 (Public Law 103–394, the National Bankruptcy Review Commission (NBRC) was created to:

investigate and study issues relating to the Bankruptcy Code;

solicit divergent views of parties concerned with the operation of the bankruptcy system;

evaluate the advisability of proposals with respect to such issues; and

prepare a report to be submitted to the President, Congress and the Chief Justice.

However, there is a widespread perception that the NBRC, composed almost exclusively of attorneys, lost its focus. The credit industry is the only industry adversely affected by every one of the estimated 1.3 million personal bankruptcy cases that will be filed this year. The credit industry is losing $30 billion dollars per year, while attorneys are profiting from bankruptcy filings. Those credit industry losses can only be recouped through higher interest rates on loans and higher fees that will be passed on to financially-responsible consumers.

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Limitations on Reaffirmations

Reaffirmation is the process by which debtors legally recommit to pay a debt that would otherwise be discharged in bankruptcy. The NBRC originally recommended that all reaffirmations be banned, but replaced the total ban with a ban on unsecured reaffirmations severe limitations on secured reaffirmations. Debtors frequently wish to retain an asset securing a loan, such as an auto used to commute to work, or to maintain a line of credit or credit card which is a necessity for renting a car or reserving a hotel room. Many borrowers choose to reaffirm their credit union obligation because of low interest rates on loans and because they wish to maintain their memberships in good standing with their credit union. The need for transportation to and- from work does not cease with a bankruptcy filing. Many credit union members, although bankrupt, recognize the good bargain they have with their credit union. Loan interest rates are at or below the norm and other financial benefits, such as free ATM cards and dividends earned on checking accounts, strengthen the long-term relationship many debtors have with their credit union.

The Commission's proposal to require court approval of reaffirmations will make this process more complex, more time consuming, and more costly to credit unions. No doubt it will also increase the cost of attorney services. At present, many bankrupt credit union members negotiate a reaffirmation agreement on the car they financed with their credit union. This is a straightforward process whereby the credit union and the debtor and his attorney agree to such basics as the monthly payment and the total to be paid. This agreement is then filed with the bankruptcy court. Under the new proposal, it is likely that the credit union will have to go to the expense of hong an attorney to ensure the new forms are completed properly and to attend the court hearings. Denying credit unions the right to reaffirm debts seriously hampers the debtor's ability to get a fresh start. The present law provides more than adequate legal protection by requiring the debtor's attorney to agree, in writing, to the reaffirmation.. Where no attorney represents the debtor, the court itself must be involved to protect the debtor's interests.

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This is an example of the Commission misinterpreting or ignoring the information available. The Commission seemed greatly concerned that many debtors reaffirmed at least one debt (no doubt, usually the car used for commuting

to work), and apparently believe that bankrupt consumers will have the cash to redeem automobiles by paying the balance in full rather than spreading payments over time through reaffirmation.

The NBRC proposal bans reaffirmation on unsecured debt, such as credit cards. Since many credit unions have policies of limiting services to members who have caused losses to credit union member-owners, bankrupt debtors would be hurt by being forced to end their long-term financial relationship with credit unions. They will incur additional costs for checking accounts, ATM cards and related financial services because they will be forced to obtain these services from banks, which typically charge high fees. They will be able to get new credit some day, but at the 17-21 percent interest rate (or greater) charged by banks for riskier credit rather than the 12-13 percent average rate charged by their credit unions.

Unnecessary Valuation Hearings

The Commission proposes that even secured creditors, secured by purchase money loans on household goods such as appliances and personal computers, participate in a court hearing or lose their security interest in the collateral. Presently, creditors who have financed such household goods need only file a proof of claim with the court. The debtor's attomey is free to dispute this claim if the attorney thinks it is invalid. The Commission has recommended that such secured claims under $500 be automatically voided. Further, the Commission would require amounts greater than $500 to be subject to a court hearing to detemmine the value of each item. This requirement is another needless burden and cost imposed on creditors, and an unnecessary and unwise use of the court's time. Conservative estimates are that hundreds of thousands of these unnecessary hearings will clog the bankruptcy system each year, just to determine the value of a personal computer or washer/dryer. Again, attorneys will benefit through increased fees.

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Uniform Exemptions

At present, there is widespread discrepancy from state to state with regard to the value of property that may be exempted from bankruptcy and kept by the debtor. The present range is from $5,000 in states such as Virginia and North Carolina, up to an essentially unlimited amount in a few "homestead" states such as Florida and Texas. This money should be used to pay the debtor's bills, rather than serving as a bonus to the bankrupt debtor while creditors must pass the loss on to responsible customers. The ability to declare bankruptcy and emerge with a nest egg encourages the avoidance of financial responsibility. Consider wealthy financier Paul Bilzerian who put $6 million dollars into his Florida estate and filed bankruptcy shortly thereafter. The $6 million was exempt under the Florida homestead law, and Mr. Bilzerian is free to sell his house and pocket the $6 million while his creditors wonder why the law allows such gross unfaimess. Households with this level of net worth should be encouraged to work out their financial problems outside of bankruptcy. Altematively, they should be required to commit to a Chapter l 3 plan in which their creditors receive substantial repayment. They should not be encouraged or allowed to use Chapter 7 bankruptcy as a financial planning tool to enhance their net worth at the expense of other consumers.

Student Loan Discharge

In the early 1 990's, student loan default rates were soaring. In response, Congress increased the amount of time, from five to seven years, that guaranteed student loans would have to be due before being eligible for a discharge in bankruptcy. The Commission is now proposing that student loans could be discharged in bankruptcy without regard to the age of the loans or without any showing of financial hardship. Student loans are made on the assumption that the education gained from the proceeds of the loan will enable the student to have a higher income potential and thus repay the loan. Allowing students to discharge their loans entirely, perhaps without paying a dime, invites abuse and does nothing to foster individual financial responsibility. Should taxpayers be expected to condone a policy that could cost them billions of dollars? Relaxing the dischargeability of student loans would decrease opportunities for financial assistance and hurt low to middle income students the most.

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Debtor Education

The Commission recommends that debtors have an "opportunity" to participate in a financial education program. It is disappointing and unacceptable that the Commission has refused to require a basic consumer education course for those who have mismanaged their finances to the extent that they must seek the protection of bankruptcy.

While it is true that not all bankruptcies are caused by financial mismanagement, a significant number are. Several recent studies have shown that as many as 20 percent of bankrupt filers find it necessary to refile for bankruptcy a second time. Any creditor can give case histories of debtors who have mismanaged their finances by charging on fifteen to twenty credit cards, overextending at jewelry stores, and purchasing luxury vehicles. These individuals could benefit from a basic program of personal financial management as a condition of receiving any relief under bankruptcy laws. Education should be required of anyone filing bankruptcy. Bankruptcy courts could exempt persons whose bankruptcy was caused solely by extraordinary circumstances such as catastrophic medical bills.

Property Valuation

The Commission's proposed methods of valuing property generally favor unsecured creditors and debtors to the detriment of secured creditors. For example, the Commission recommends that secured claims in real estate be determined by the property's fair market value minus hypothetical costs of sale. The Commission also recommends that secured claims in debtors' personal property be determined by the property's wholesale value.

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It is imperative that the value of both real estate and personal property claims reflect fair retail market value. Creditors have been criticized for making easy unsecured credit available based on the prospects for repayment from the future income of borrowers. The Commission's proposed method of valuation which favors unsecured creditors at the expense of secured creditors would likely promote the very type of unsecured credit that may have initially caused the debtor's financial difficulties. The proposal to reduce the value of secured claims undermines the very basic and traditional principles (i.e., providing credit based on security interests in tangible property) of risk management for time-tested and responsible lending programs. Additionally, the Commission's proposals on property valuation will push the costs of credit higher, restrict lending, and further alienate marginal prospective borrowers from access to responsible credit programs.

Home Mortgages

The Commission proposes that in Chapter 13 cases, a junior lien on the debtor's principal residence may be reduced to the value of the property at the time the loari was granted. This proposal would result in increased second mortgage losses for financial institutions, and would lead to higher loan interest rates for all consumers.

Many second mortgages are made for home improvement purposes. Therefore, if the Commission's proposal is adopted, it should be modified to recognize the added value of home improvements made with loan funds secured by the junior lien. Failure to recognize the value of home improvements in the proposed second mortgage cram downs will further jeopardize a significant proportion of the requests by consumers for equity loans to make home improvements.

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PROPOSED REVISIONS TO THE BANKRUPTCY SYSTEM

Why are financial institutions, particularly member owned credit unions, so convinced that the bankruptcy system needs reform? The answer is simple. Bankruptcy losses at some credit unions (losses that must be borne by responsible credit unions members) have increased dramatically under the present law. As much as 60 to 70 cents of every dollar

lost is due to bankruptcy. Credit unions, in particular, have very small operating margins, often paying their member-owners 6 percent or more for capital, while making car loans at competitive rates of 7–8 percent. This leaves little room for bankruptcy losses which have recently increased as much as 25–30 percent per year at some credit unions. In addition to loan losses, credit unions are spending huge sums of money on attorneys' fees to file the necessary forms to retain collateral and object to obvious abuses.

It is clear that certain changes to the existing Bankruptcy Code are necessary in order to reverse this recent trend and restore a sense of responsibility and accountability to the bankruptcy system. A discussion of the primary issues follows in this Part III while the Appendix includes a list of specific changes to the current Bankruptcy Code that would implement the primary NAFCU recommendations and address additional procedural and administrative concerns.

Require Chapter 13 consideration before establishing eligibility for Chapter 7

There are several reasons for this basic requirement, which is also referred to by some advocates as "needs based" bankruptcy. Today, bankruptcy courts do not require any showing of need or minimum level of debt. Alternatives to bankruptcy are not considered, nor is any independent review of a debtor's situation conducted. Under the present law, the bankruptcy court simply accepts the debtor's assertion that bankruptcy is necessary. This is contrary to the adversarial nature of the U.S. judicial system. As a result, Chapter 7 often gives more relief than is necessary.

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The full discharge of debts provided by Chapter 7 is a carryover from the last century, when most credit was secured by tangible assets. Today's consumer-based economy is built on unsecured revolving credit with the promise that debtors will pay from future income.

Another central underpinning of the bankruptcy system was the idea that a sense of personal responsibility would deter bankruptcy filings. Bankruptcy carried a heavy stigma until the last two decades. Then a variety of factors, including the proliferation of attorney advertising and media attention focused on corporate bankruptcy began to erode the sense of responsibility that had previously existed. If we are going to restore responsibility by requiring the use of Chapter 13 in those cases where it is warranted, then we need to take certain steps to improve the Chapter 13 process so that more consumers successfully complete repayment plans.

Additionally, the Bankruptcy Code should establish consistent rules and procedures for processing creditors' claims and payments. Guidelines should be established for developing personal and family budgets for use in Chapter 13 repayment plans. Uniform methods of recognizing claims and remitting payments to creditors must be adopted. Currently, some courts require creditors to file proofs of claim only with the court. Others require copies to be filed with trustees or debtors' attorneys or both. Failure to follow specific requirements may result in creditors' claims being disallowed or unpaid. Moreover, some jurisdictions provide "adequate protection" payments to secured creditors while others wait until the plan is confirmed before remitting payments. If, as in some jurisdictions, the confirmation is six months after the bankruptcy is filed, secured creditors receive no payments on loans while debtors have the use of vehicles or other collateral securing loans. These kinds of differences should be eliminated and a uniform process should be established to provide consistent and efficient bankruptcy procedures.

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Uniform Exemptions

At present, there is widespread discrepancy among the states with regard to the value of personal property that may be exempted from bankruptcy and kept by the debtor. The present range is from approximately $5,000 to an essentially unlimited amount in a few "homestead" states such as Florida and Texas. This money should be used to pay the debtor's bills, rather than serving a bonus to the debtor while creditors take a loss. The ability to declare bankruptcy and emerge with a substantial nest egg encourages the avoidance of financial responsibility.

NAFCU believes total uniform exemptions, with no provisions for states to opt out, should be within the range of $15,000 to $30,000. Guidelines should be established to provide that debtors having an earning capacity above the national median income would be provided a $15,000 exemption while those with lower earning capacities could receive higher exemptions not to exceed $30,000.

Mandatory Financial Education for Bankruptcy Filers

Credit unions have a long history of educating their members in financial matters. The wise use of credit as well as the value of systematic savings are basic credit union principles. A recent survey by the Opinion Research Corporation International found one in four Americans believe they have debt management problems. Nearly 50 percent stated they would be stronger money managers if they could improve their financial skills through training. It is disappointing and unacceptable that the Commission has refused to require a basic consumer education course for those who have mismanaged their finances to the extent that they must seek the protection of the bankruptcy courts.

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While it is true that not all bankruptcies are caused by financial mismanagement, a significant number are. Several recent studies have shown that as many as 20 percent of debtors find it necessary to refile for bankruptcy a second time. We do not advocate requiring consumers who have filed bankruptcy due to severe medical bills or long term unemployment to undergo financial education. However, any creditor can give case histories of debtors who have mismanaged their finances by charging on fifteen to twenty credit cards, over-extending at jewelry stores, and purchasing luxury vehicles. These individuals could benefit from a basic program of personal financial management as a condition of receiving any relief under bankruptcy laws. Just as many states require remedial training for those who abuse driving privileges, the Bankruptcy Code should require those who seek bankruptcy protection to participate in a personal financial management training program. Funding for such a project could be provided either by creditors or through a small increase in the bankruptcy court fee structure. Furthermore, many non-profit organizations, such as Consumer Credit Counseling Service, provide guidance in household budgeting.

Revise Automatic Stay Provisions

At present, when a debtor files bankruptcy, an automatic stay or freeze applies to all activity by creditors. If a debt is secured by a car, this means that no action can be taken to gain possession of the vehicle. The purpose of this automatic stay is to allow the debtor to make arrangements to retain the car, by paying in full or continuing monthly payments. The present law provides that the debtor has 45 days to inform the creditor of his or her intentions regarding the collateral. Most debtors ignore this rule, leaving the creditor to guess about their intentions, while they continue to drive the car often without insurance and frequently with no intent to repay. The 45day time frame is excessive—debtors have already decided this issue during pre-bankruptcy discussions with their attorneys.

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Under the current system, a credit union must file the necessary paperwork with the court proving that the credit union does have a legitimate claim to the vehicle. This is a simple matter of providing photocopies of titles and loan contracts; but in most cases, credit unions find it necessary to hire an attorney. The prevailing charge for filing these forms to "lift the stay" is from $350 to $500, a cost that many small credit unions cannot afford. Alternatively, the credit union can wait until the court terminates the stay at the time of discharge, which is typically four to six months. Of course in the meantime, no payments are received, the car depreciates in value, and there is risk of damage in an accident. It is patently unfair to place these additional costs and burdens on a creditor when it is undisputed by any party that the creditor is entitled to regain possession of the vehicle.

The automatic stay should terminate when the notification period expires. The present 45 day notification period should be shortened to 10 days. This would apply only to secured creditors and the recovery of collateral. Other provisions of the stay relating to attempts to contact the debtor or collect the debt would remain in effect.

Debtors seeking bankruptcy protection often permit insurance on collateral to lapse. This shifts the risks of uninsured collateral to the creditor while the collateral remains in possession of the debtor under protection from repossession by the automatic stay. Debtors should be required to include, with the schedules and statements accompanying petitions for bankruptcy, evidence of insurance on collateral as specified in loan agreements. Failure to provide evidence of insurance, consistent with the loan agreements, should exempt debts secured by inadequately insured collateral from the automatic stay.

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In Chapter 13 cases, a debtor may elect to handle a secured loan, such as a vehicle loan, outside the plan by making payments directly to the secured creditor. Under present law, the automatic stay continues in full force and effect, even with respect to collateral for obligations being paid outside the plan, until the plan payments have been completed. The Code should be revised to provide an exception to the automatic stay providing for termination of the stay upon confirmation of the plan with respect to the collateral for obligations which are being handled outside the plan.

Strengthen and Clarify the Right of Reaffirmation

Credit unions traditionally have higher reaffirmation rates than many other lenders, partly because their members realize that credit unions offer them low interest rates on loans and high dividend rates. The higher credit union reaffirmation rates reflect other characteristics of the credit union philosophy such as the knowledge that fellow credit union members will bear the costs of any debts discharged in bankruptcy, the fact that the standard bylaws for federal credit unions provide that loans will be made for provident or productive purposes, and the traditional emphasis placed on member financial education by credit unions. Credit union members and other consumers should be assured that they can retain their relationships with their financial institutions by reaffirming loans at reasonable rates, rather than being forced to pay higher prices elsewhere. Therefore, NAFCU believes the Bankruptcy Code should be clarified to include the purpose of debt reaffirmation and strengthened to ensure each debtor's right to enter into reaffirmation agreements on both secured and non-secured debt.

In Chapter 7 cases, if a debtor wishes to retain collateral, the Code should specifically require that the debtor redeem the collateral or enter into a binding reaffirmation agreement with the secured creditor. Case law indicating that a debtor can retain possession of the collateral simply by maintaining the monthly payments under the loan agreement while the debtor's personal liability for making those payments is discharged in bankruptcy should be eliminated by appropriate amendments to the Bankruptcy Code.

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Composition of Review Commission

Notwithstanding the elaborate scheme established for appointing the current NBRC, we believe the Commission was too "stacked" towards the legal profession and, consequently, placed too much emphasis on "debtor versus creditor" confrontations and the procedural legal framework governing those contentious encounters of debtors and creditors. A more balanced Commission may have placed additional emphasis on thoroughly understanding the causes and effects of the various components of the bankruptcy system and on seeking to build consensus that would foster improving responsibility and accountability among all consumers and throughout the credit industry. While it is true that both creditor and debtor representatives were given ample opportunity to testify before the Commission, testifying in and of itself is a poor substitute for having the benefit of frank peer level discussions that should take place on a well-balanced Commission.

Because of sharply changing attitudes towards bankruptcy and the potential for adverse impact on both consumers and businesses, NAFCU recommends establishing a Bankruptcy Advisory Council comprised of representatives reflecting the interests and concerns of both consumers and the credit industry. Such a Council could be established under the auspices of the Department of Justice. Alternatively, the Federal Reserve Board's existing Consumer

Advisory Council could be required to prepare an annual report to Congress on bankruptcy issues.

NAFCU'S PROPOSALS TO IMPROVE THE BANKRUPTCY SYSTEM—CONT.

The National Association of Federal Credit Unions proposes the following specific changes in the Bankruptcy Code and in the Federal Rules of Bankruptcy Procedure as they would apply to consumer or personal bankruptcy cases in order to promote financial responsibility and to reduce the administrative burdens of the bankruptcy system.

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Revise 301 and 707 of the Code to provide that a petition must receive full consideration under Chapter 13 before establishing eligibility for consideration under Chapter 7. Revise 707 of the Code to permit creditors to enter a motion for dismissal of a Chapter 7 filing based on the debtor's capacity to earn sufficient income to permit repayment of debts under a Chapter 13 plan.

Modify 1322 of the Code to extend the Chapter 13 plan to provide for payments over a period of 5–7 years and, for cause, to permit the court to approve a longer reasonable period, without statutory limitation.

Amend the Code to establish a nationwide database to discourage abuse through multiple filings in multiple jurisdictions.

Amend the Code and Rules to provide for greater uniformity in procedures, forms and practices of the various bankruptcy courts.

Revise 341 of the Code and Rule 2003 to provide explicit authority for creditor participation at 341 hearings.

Modify 342 of the Code and Rule 2002 to require that any loan account numbers be provided in the notice to a creditor.

Amend 362 of the Code to establish an exception to the automatic stay which involves joint debt when one or more joint debtors files a subsequent petition for relief within 120 days of a prior filing by any other joint debtor.

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Revise 362 of the Code to establish an exception to the automatic stay for debtors wishing to voluntarily convey collateral to creditors.

Revise 362 of the Code to establish an exception to the automatic stay when a Chapter 13 debtor falls more than 60 days behind the scheduled repayments.

Revise 362 of the Code to permit an exemption to the automatic stay for creditors to continue accepting payments on loans for collateral that debtors intend to retain the collateral.

Amend 362 and 521 of the Code and Rule 1007 to stipulate that debtors must provide evidence of insurance on collateral consistent with the loan agreements and that failure to provide such evidence would grant exception to the automatic stay with respect to such collateralized loans.

Amend 506 of the Code to provide that the value of collateral retained for use by the debtor and the value for determining secured claims shall be retail fair market value.

Amend 521 of the Code to require debtors, who have not completed a personal financial management course in the previous 180 days, to complete appropriate financial counseling and training within 45 days after filing a petition, otherwise the petition will be automatically dismissed.

Revise 521 of the Code and Rule 1007 to more clearly establish the debtor's financial situation to include:

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(a) A verifiable record of financial events (reduced income, increased expenses, etc.) that clearly show how the debtor's financial problems came to need relief through bankruptcy proceedings.

(b) Evidence to clearly establish the prospects for the debtor's future capacity to liquidate current debt.

(c) A requirement that the debtor provide copies of the three most recent Federal income tax returns or data therefrom.

Modify 521 of the Code to require debtors to list all 'potential creditors' under existing open end credit contracts that have a zero credit balance and revise Rule 2002 to require notification of such 'potential creditors' that the debtor has filed a petition for bankruptcy.

Amend 521 of the Code to provide for automatic dismissal of a petition if the debtor's notice of intent is not provided within the specified 10 days or if the performance of such notice of intent is not completed within a reasonable period, but not later than the first meeting of creditors.

Revise 521 of the Code to stipulate that false, incomplete or inaccurate information will result in automatic dismissal. Just as time limits are established in Rule 1007, a Rule should provide guidelines for complete and accurate information.

Amend 522 of the Code to provide uniform exemptions and to limit total exemptions to $15,000 to $30,000 with guidelines providing that debtors having an earning capacity above the national median income would be provided a $15,000 exemption while those with lower earning capacities could receive higher exemptions not to exceed $30,000.

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Amend 523 of the Code and Rule 4004 to simplify requirements and procedures for creditors to show false pretenses in connection with loans obtained within 60 days (we recommend 180 days) of the order for relief

Modify 523 of the Code to extend the period of obtaining a loan for luxury items from 60 days to 180 days prior to order for relief and reducing the thresholds for cash advances and purchase of luxury items from $1000 to $100.

Modify 523(d) of the Code to stipulate that costs of a successful dischargeability challenge by the creditor will be borne by the debtor.

Amend 547 of the Code to exempt transfers made to creditors who neither know nor have reason to know of the debtor's insolvency.

Amend 725 of the Code to specify that the debtor may only retain collateral by redemption as provided in 722 of the Code or by reaffirmation agreement as provided in 524 of the Code.

Amend 727 of the Code and Rule 4005 to stipulate that costs of a creditor's successful objection to the discharge will be borne by the debtor.

Rescind provisions of 1301 of the Code that prohibit collection from a non-bankrupt co-debtor until the automatic stay is lifted.

Revise Rule 3015 to extend the amount of time a creditor has to object to an amended plan from 20 days to 30 days.

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Revise Rule 3015 to automatically provide a copy of the plan to the creditor.

Revise 1321, 1323, and 1324 of the Code to require copies of modifications and final confirmed plans to be mailed to creditors.

Revise 1322, 1325, and 1326 of the Code and Rule 3015 to insure that all disposable income will be distributed to creditors for the full term of the plan or until the creditors are paid in full.

Amend 1322 of the Code to establish statutory guidelines for individual debtor expenditures (i.e., Form 6, Schedule J) for Chapter 13 plans. Individual living expenses should be limited to essential items for the individual and should not be permitted to exceed the locality's median expenditure level for each item. Exceptions could be documented and approved by the court for extraordinary and unique situations such as professionally certified medical needs of the individual.

Amend 1322 of the Code to prohibit the modification of the rights of holders of secured claims that are secured by an interest in real property.

Revise 1326 of the Code to require payments to secured creditors prior to plan confirmation.

For Chapter 13 cases, amend 362 and 1301 of the Code to provide for termination of the automatic stay with respect to collateral for obligations which are being handled outside the Chapter 13 plan.

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APPENDIX D—NAFCU'S BANKRUPTCY SURVEY

NAFCU MEMBER RESPONSES TO NAFCU'S PROPOSAL TO IMPROVE THE BANKRUPTCY SYSTEM

1. Should debtors who are able to repay a portion of their debts be required to file a Chapter 13 (restructuring) rather than a Chapter 7 (liquidation) bankruptcy?

Ninety-seven percent of respondents support a needs-based bankruptcy system. NAFCU members believe that a needs-based system win increase debtor accountability, create a fairer bankruptcy system, and more fairly distribute payments among all creditors. Reform to create a needs-based system should include changes to Chapter 13 which will reduce the Chapter 13 failure rate and factor future earning capacity into repayment plans.

2. Under the current law, a Chapter 13 repayment plan may only last from three to five years. Should this period be increased? If yes, how many years should the plan cover?

Sixty percent of respondents believe this period should be extended The majority of these members suggest seven to ten year repayment plans. Other members support lengthening repayment plans only if Congress enacts meaningful reform of Chapter 13 to encourage debtors to complete Chapter 13 plans as well as eliminate flaws in the Chapter 13 system which contribute to failures. Suggested reforms include increasing incentives for completing a repayment plan in which all creditors receive substantial repayment and implementing a needs-based system which prohibits debtors from converting to Chapter 7 if they meet certain guidelines.

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3. Should the bankruptcy code mandate uniform federal exemptions? If yes, what is an appropriate homestead exemption? What is an appropriate exemptions for all other personal property?

Eighty-three percent of respondents support uniform federal exemptions. However, the specific dollar amount of

exemptions vary widely. The vast majority (76 percent) support exemptions under $30, 000.

4. Should a debtor who does not use a homestead exemption be permitted to exempt additional personal property?

Eighty-six percent of respondents oppose providing an additional personal property exemption to a debtor who does not use a homestead exemption.

5. Currently a debtor must notify a creditor whether the debtor intends to reaffirm or redeem collateral within 45 days of filing bankruptcy. Should this period be reduced? If so, what is an appropriate length of time?

Eighty-four percent of respondents advocate reducing this period. They believe that debtors engage in pre-bankruptcy planning with their attorneys and have decided which assets they will keep and which they will surrender before filing bankruptcy. In the period between filing bankruptcy and notifying creditors of intent, the debtor uses the collateral without making loan payments and without maintaining adequate insurance.

6. If the debtor does not notify the creditor of his intent to redeem or reaffirm within the statutory period, should the creditor be able to repossess the collateral?

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Ninety-five percent of respondents believe that a creditor should be permitted to repossess collateral if a debtor fails to fulfill his obligation to inform the creditor of his intent to ready reaffirm, redeem, or surrender within the statutory period. Failure to notify should trigger an automatic lifting of the stay, with no action required by any creditor. Such a provision would protect the value of a creditor's lien by allowing a creditor to take prompt action to repossess and sell the collateral.

7. Should a creditor be permitted to initiate collection efforts if a Chapter 13 debtor falls more than 60 days behind in the repayment schedule?

Ninety-four percent of respondents support this proposition. Credit unions see much abuse in this area—borrowers are delinquent in their payments to the trustee, debtors only make six to nine payments per year, and trustees fail to take action to correct these problems. Under the current code, a creditor has little recourse in such situations.

8. Should debtors be able to reaffirm debts?

An overwhelming majority (97 percent) of respondents support ready reaffirmation. Reaffirmation agreements allow debtors to maintain relationships with financial institutions and to keep property needed to become a financially responsible member of society, such as a vehicle needed for commuting to work. Our members feel that any agreement to reaffirm a debt should be a contractual agreement between the debtor and the creditor.

9. If debtors are allowed to reaffirm should the bankruptcy code include any limitations on a debtor's ability to reaffirm?

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Seventy-six percent of respondents believe that the bankruptcy code should not include any limitations on the right to reaffirm. These members argue that reaffirmations are a contractual agreement between the debtor and the creditor in which the bankruptcy court should not be involved. Those who support limitations generally advocate minor limitations. Members support a requirement that the debtor's attorney approve any reaffirmation, as well as requirements that debtors be fully informed about reaffirmation agreements and the corresponding responsibilities.

10. Are the administrative requirements associated with bankruptcy overly burdensome for credit unions?

Sixty-two percent of respondents stated that administrative requirements associated with bankruptcy are overly burdensome for credit unions. Members commented that trustees will not permit a credit union to participate in the meeting of creditors without an attorney. Other members argue that the cost of objecting to a discharge is great with minimal chance of success. Credit unions with members in more than one state find that administrative requirements vary from state to state, requiring creditors to learn the procedures in all states where their members may live.

11. Should debtors be required to participate in credit counseling before filing bankrupt"?

Eighty-four percent of respondents support this requirement. They argue that debtors should be educated about bankruptcy and its ramifications, as well as alternatives to bankruptcy by unbiased financial counselors. Furthermore, they believe that financial education will help debtors avoid future bankruptcies. Members support federal guidelines delineating necessary characteristics of financial education programs.

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12. Do you grant second mortgages or home equity loans for more than 100 percent of the appraised value of the home?

Only 7 percent of respondents grant such loans. Members who do not grant loans with loan-to-value ratios above 100 percent argue that lenders offering these programs are merely preying on unsophisticated consumers.

13. Should debtors who complete a Chapter 13 payment plan receive a more favorable credit bureau rating than those who complete a Chapter 7?

Eighty-six percent of respondents support this proposition. Members noted that, a debtor who pays 90percent of unsecured debts in a Chapter 13 is much more creditworthy than a debtor who only pays one percent of unsecured debts. Thus, consumer reports should indicate whether a debtor filed a Chapter 13 or a Chapter 7 as well as the percentage of unsecured debts paid under the plan.

14. Should a debtor's credit bureau report show whether a debtor completed a credit planning course?

Seventy-two percent of respondents supported this suggestion. These members argue that the fact that a debtor had completed a credit planning course would be a relevant factor in a lending decision. In addition, attending a credit planning course may indicate that a consumer is having credit problems and may encourage a creditor to look more closely at an application.

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Mr. **GEKAS.** We thank the gentleman, and we turn to the testimony of Ms. Miller.

STATEMENT OF JUDITH GREENSTONE MILLER, LEGISLATIVE COUNSEL, BANKRUPTCY AND INSOLVENCY SECTION, REPRESENTING THE COMMERCIAL LAW LEAGUE OF AMERICA

Ms. **MILLER.** Good morning and thank you for inviting me to testify as a witness before the subcommittee.

My name is Judith Greenstone Miller. I'm an attorney and a member of the Birmingham, Michigan Office of Clark Hill P.L.C., and a member of the Commercial Law League of America. The League founded in 1895, is the Nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization, with a membership exceeding 4,600 individuals.

I am honored to address the subcommittee on H.R. 3150, H.R. 2500, and H.R. 3146, and have been asked to speak about the impact of these consumer proposals on unsecured creditors. The League believes that the adoption of many of the consumer proposals contained in H.R. 3150 and H.R. 2500 will enhance the rights of unsecured creditors.

Reform is appropriate in circumstances where abuse has been prevalent, such as (1) when debtors incur debts on the eve of bankruptcy when they are clearly insolvent, in financial distress or in all likelihood unable to pay for the goods or services, or (2) when debtors obtain advances and such funds are used to extinguish priority or nondischargeable claims.

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H.R. 3146, however, appears to be based on the premise that virtually all of the financial ills faced by consumers today and the increased in bankruptcy filings are caused credit grantors. Credit card issuers in particular cases seem to bear the brunt of the legislation. It is the opinion of the League that H.R. 3146 is unnecessarily punitive and its provisions are onerous.

Responsible people may disagree on some of the specific provisions in H.R. 3150 and H.R. 2500, however, the League believes these two bills provide a more balanced and equitable approach to the very real and troubling financial problems being faced by consumers. While the League generally supports the consumer proposals contained in H.R. 3150 and H.R. 2500, I'd like to make the following observations:

Section 141 of H.R. 3150 and Section 106 of H.R. 2500, are supported by the League. At the same time the League recognizes that these provisions do not contain any time limits, and ultimately the benefit to be derived by the unsecured creditor who has advanced the credit will depend on its ability to trace the funds advanced.

With respect to Section 142 of H.R. 3150 and Section 107 and H.R. 2500, the League recognizes that certain debts incurred on the eve of bankruptcy may be entitled to additional safeguards geared toward repayment. However, the section, as drafted, is overly expansive. It shifts the burden to prove the claim is dischargeable from the creditor to the debtor. With such limited funds and resources, debtors are unlikely to be able to rebut the presumption of nondischargeability, thereby impairing their fresh start which bankruptcy is intended to provide.

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In its written materials, the League has suggested an alternative 2-prong approach:

One, shorten the time period for the rebuttable presumption from 90 to 30 days, and;

Two, increase the time period for nondischargeability for purchases of luxury goods from 60 to 90 days.

This alternative 2-prong test would address the concerns of unsecured creditors by protecting them from nonpayment for goods purchased by the debtors on the eve of bankruptcy and, at the same time, provide debtors experiencing financial difficulties disincentives to purchase luxury goods, while at the same time preserving the debtor's fresh start and providing fairer treatment to honest debtors, not otherwise abusing the system.

The League supports the adoption of Section 143 of H.R. 3150 and Section 104 of H.R. 2500. This represents sound public policy, is consistent with chapter 7 substantive law, and as a consequence, debtors will no longer be able to discharge such debts by electing chapter 13 treatment.

The League also supports Section 145 of H.R. 3150. However, as proposed, the amendment is likely to present significant evidentiary problems. Therefore, if Congress seeks to provide unsecured creditors with a tangible and effective remedy, the subcommittee may wish to consider inclusion of a codified standard setting forth specific factual criteria to prove the debtor's financial state at the time the debt was incurred.

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The League also supports Section 181 of H.R. 3150. It would impact bankruptcy planning by debtors and negate forum shopping for the purpose of exempting property from the estate.

With respect to Section 109 of H.R. 2500, the League believes that this provision is extreme and will result in impairing the delicate balance contained in the Bankruptcy Code, and further impact fair treatment to debtors.

With respect to Section 113 of H.R. 2500, although the League does not believe such a study is necessary, they would support a study with respect to exemptions. We also support the National Bankruptcy Review Commission's recommendations insofar as they foster and promote uniformity of exemptions on a national basis to preclude forum shopping, but not necessarily the limits contained in the Final Report.

One final section I'd like to address. And, with respect to Section 210 of H.R. 2500, we also support it, and believe that enhanced mandatory disclosure will provide additional information early on for creditors to assess the financial condition of the debtor, a benefit to creditors.

Thank you very much for inviting me to testify before the subcommittee this morning. I will be happy to respond to any additional inquiries and concerns the subcommittee would have.

[The prepared statement of Judith Greenstone Miller follows:]

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PREPARED STATEMENT OF JUDITH GREENSTONE MILLER, LEGISLATIVE COUNSEL, BANKRUPTCY AND INSOLVENCY SECTION, REPRESENTING THE COMMERCIAL LAW LEAGUE OF AMERICA

Good morning and thank-you for inviting me to testify as a witness before the House Judiciary Committee's Subcommittee on Administrative and Commercial Law. My name is Judith Greenstone Miller. I am an attorney and a member of the Birmingham, Michigan office of Clark Hill P.L.C., and a member of the Commercial Law League of America, its Bankruptcy and Insolvency Section, and its Creditors' Rights Section. The CLLA, founded in 1895, is the nations oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization, with a membership exceeding 4,600 individuals.

I am honored to address the Subcommittee on H.R. 3150, H.R. 2500 and H.R. 3146, and have been asked to speak about the impact of these consumer proposals on unsecured creditors. The League believes that adoption of many of the consumer proposals contained in H.R. 3150 and H.R. 2500 will enhance the rights of unsecured creditors. Reform is appropriate in circumstances where abuse has been prevalent, such as (i) when debtors incur unsecured debt on the eve of bankruptcy when they are clearly insolvent, in financial distress or in all likelihood unable to pay for the goods or services, or (ii) when debtors obtain advances and such funds are used to extinguish priority or nondischargeable claims.

H.R. 3146 appears to be based on the premise that virtually all of the financial ills faced by consumers today and the increase in bankruptcy filings are caused by credit granters. Credit card issuers in particular cases seem to bear the brunt of the legislation. It is the opinion of the CLLA that H.R. 3146 is unnecessarily punitive and ItS provisions are onerous.

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Reasonable people may disagree on some of the specific provisions contained in H.R 3150 and H.R. 2500, however, the CLLA believes that those two bills provide a more balanced and equitable approach to the very real and troubling financial problems being faced by consumers today. While the CLLA generally supports the consumer proposals contained in H.R. 3150 and H.R. 2500, the CLLA wishes to make the following observations and comments:

1. Section 141 of H.R. 3150 and Section 106 of H.R. 2500 grant en unsecured creditor who advances funds used to pay a priority or nondischargeable claim the same attributes as the ultimate recipient of the funds. The CLLA supports this proposal, but at the same time recognizes that it does not contain any time limits, and ultimately the benefit to be

derived by the unsecured creditor who has advanced the credit will depend on its ability to trace the funds advanced.

2. Section 142 of H.R. 3150 and Section 107 of H.R 2500 grant nondischargeable status to debts incurred within 90 days of bankruptcy, thereby providing such unsecured creditors with the ability to seek repayment outside the bankruptcy case. While the CLLA recognizes that certain debts incurred on the eve of bankruptcy may be entitled to additional safeguards geared toward repayment, the CLLA believes that the section, as proposed, is overly expansive. It shifts the burden to prove the claim is dischargeable from the creditor to the debtor, which involves the commencement of an adversary proceeding. With such limited funds and resources, debtors are unlikely to be able to rebut the presumption of nondischargeability—thereby impairing the "fresh start" which bankruptcy is intended to provide them. In its written materials, the CLLA has suggested an alternative 2-prong approach, which Congress may wish to consider:

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(i) shorten the time period for the rebuttable presumption from 90 to 30 days, and

(ii) increase the time period for nondischargeability for purchases of luxury goods from 60 to 90 days.

This alternative 2-prong test would address the concerns of unsecured creditors by protecting them from nonpayment for goods purchased by debtors on the eve of bankruptcy and provide debtors experiencing financial difficulties disincentives to purchase luxury goods, while at the same time preserving the debtor's "fresh start" and providing fairer treatment to honest debtors, not otherwise abusing the system.

3. The CLLA supports the adoption of Section 143 of H.R. 3150 (which is more expansive than its parallel provision in H.R. 2500) and Section 104 of H.R. 2500, which generally make fraudulent debts incurred in a Chapter 13 bankruptcy proceeding nondischargeable. This represents sound public policy, is consistent with Chapter 7 substantive law, and as a consequence, debtors will no longer be able to discharge such debts by electing Chapter 13 treatment.

4. The CLLA also supports Section 145 of H.R. 3150, which proposes to amend Section 523(a)(2) and make nondischargeable debts incurred by a debtor when there is "no reasonable expectation of repayment." However, as proposed, this amendment is likely to present significant evidentiary problems. Therefore, if Congress seeks to provide unsecured creditors with a tangible and effective remedy under these circumstances, the Subcommittee may wish to consider inclusion of a codified standard setting forth specific factual criteria to prove the debtor's financial state at the time the debt was incurred.

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5. The CLLA supports Section 181 of H.R. 3150, which proposes to increase the time period an individual must be domiciled in a state from 180 to 365 days in order to take advantage of a particular state's exemption scheme. Adoption of this provision would impact bankruptcy planning by debtors and negate forum shopping for the purpose of exempting property from the estate. Moreover, in some circumstances, it may result in an increase of the property of the estate to be liquidated by the trustee, thereby increasing the pot of funds available for unsecured creditors.

6. Section 109 of H.R. 2500 proposes that the automatic stay terminate 30 days after the filing of a petition if a prior petition was dismissed under Chapter 7 unless the subsequent petition was filed in "good faith." The CLLA believes that this provision is extreme and will result in impairing the delicate balance contained in the Bankruptcy Code, and further impact the fair treat to be accorded debtors.

7. Section 113 of H.R. 2500 recommends the establishment of a Bankruptcy Exemption Study Commission. While the CLLA does not believe that a study is necessary because the National Bankruptcy Review Commission (the "Commission") extensively reviewed this issue, nevertheless, the CLLA would support such a study. The CLLA also supports the recommendations of the Commission in so far as they foster and promote "uniformity" of exemptions on a national basis to preclude forum shopping. However, the CLLA does not necessarily support the limits contained in the

Commission's Final Report.

8. Section 210 of H.R. 2500 expands the debtor's duties upon commencement of a bankruptcy proceeding to file various financial documents (federal tax returns, evidence of payments received, monthly net income projections and anticipated debt or expenditure increases). Debtor's compliance under this provision is required within 10 days of the request by a Chapter 7 or Chapter 13 creditor. The CLLA believes that such enhanced mandatory disclosure will provide additional information for creditors to assess the financial condition of the debtor, a benefit which the CLLA endorses.

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The Commercial Law League of America appreciates the invitation to testify on H.R. 3150, H.R. 2500 and H.R. 3146 and their impact on unsecured creditors. I would be happy to respond to any additional inquires or concerns of the Subcommittee contained in my presentation, the written materials or other provisions of these bills. Thank you.

PREPARED STATEMENT OF COMMERCIAL LAW LEAGUE OF AMERICA

INTRODUCTION

The CLLA, founded in 1895, is the nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. Its membership exceeds 4,600 individuals. The CLLA has long been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest.

The Creditors' Rights Section of the CLLA consists of over 1,200 attorneys from throughout the country who are actively engaged in commercial ligigation and in the representation of creditors in business transactions

The Bankruptcy and Insolvency Section of the CLLA is made up of approximately 1,600 bankruptcy lawyers and bankruptcy judges from virtually every state in the United States. Its members include practioners with both small and large practices who represent divergent interests in bankruptcy cases.

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The CLLA has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization field.

Most recently four major pieces of legislation have been introduced into Congress to address problems and concerns with the bankruptcy system. This follows on the heels of a two year study by the National Bankruptcy Review Commission as mandated by Congress in 1994.

The CLLA created a "blue ribbon task force" of representatives of the Bankruptcy & Insolvency Section and the Creditors' Rights Section to analyze and develop positions on these pieces of legislation. In particular the tast force focused on consumer and creditor issues as contained in H.R. 3150.

SPECIFIC SELECTED SECTIONS OF H.R. 3150

Section 101: Needs-based bankruptsy

The CLLA agrees that there have been a number of abusive situations that have arisen as a result of the current Bankruptcy Code. Horror stories abound and are reported in the media about the wealthy who take advantage of the system to eliminate debts while maintaining a lifestyle that some would call opulent.

There is no question that this apparant flaunting of the system must be addressed.

Individuals with large debt loads but who have an income level that allows for some repayment of debts while still providing sufficient funds for living expenses should be expected to reduce their outstanding debt in line with their economic ability.

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However, a fixed formula for determining who is able to so participate conflicts with of many of the concepts underlying bankruptcy.

The Bankruptcy Court is a court of equity. It is more than a finder of fact and then applying the appropriate law to those facts. Rather, the bankruptcy process involves numerous parties, all with differing interests that must be evaluated within the context of the Bankruptcy Code. The Court often must weigh and attempt to balance the need for a fresh start for a debtor against the best interest of the estate and the creditors.

A fixed formula as outlined in H.R. 3150 and other similar bills eliminates one of the most crucial attributes of the bankruptcy system—the discretion of the court.

There are many variables that form the basis for why an individual files for bankruptcy protection. The debtor's age, health, years to retirement, number of dependents, physical abilities or disabilities are just a few of the many factors that can influence why bankruptcy was filed and the outcomes that are likely from that filing.

A fixed formula does not take these and the myriad of other factors into account.

Recognizing that there are flaws that must be addressed, the CLLA recommends that in lieu of a needs-based bankruptcy formula that specific authority be given to the court to convert a Chapter 7 filing to a Chapter 13 case.

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The trigger would be a motion filed by a party in interest. The standard would be "the best interests of the estate and its creditors".

Both the mechanism and the criteria are well founded under the Bankruptcy Code. This approach recognizes the ability of the bankruptcy court to act as a court of equity. It provides protection to creditors from abusive debtors while at the same time, providing the Court with the opportunity to evaluate the court to consider the unique circumstances which surround a particular case.

Once a case has been converted to Chapter 13 a large body of case law already exists to aid the parties and the court in crafting a plan that properly balances the competiting bankruptcy interests.

Section 123: Debtor retention of personal property security

The CLLA SUPPORTS this proposed amendment to Section 521 of the Bankruptcy Code. This places upon the debtor an affirmative duty to act within a reasonable time period of 30 days after the 341 meeting to either reaffirm or to redeem secured property.

Section 124: Relief from stay when the debtor does not complete intended surrender of consumer debt collateral

The CLLA SUPPORTS this proposed amendment to Section 362 of the Bankruptcy Code. This appears to codify the existing state of the law and provide that the creditor may proceed without violating the automatic stay when the debtor fails to perform certain duties required under the Bankruptcy Code.

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Section 125: Giving secured creditors fair treatment in chapter 13

The CLLA SUPPORTS this proposed amendment to Section 1325(a)(5)(B)(i) of the Bankruptcy Code. This provision would allow the holder of a lien to retain that lien if the Chapter 13 case is converted or dismissed or until the debt has been either discharged or payment made under non bankruptcy law.

Section 126: Prompt relief from stay in individual cases

The CLLA OPPOSES the proposed amendment to Section 362(e) of the Bankruptcy Code. This appears designed to make certain that a decision on a request for relief from the automatic stay is not unduly delayed by the continual postponement of a final decision by the court. The CLLA's experience is that with rare exception, the current practice works well and this amendment is not warranted.

Section 127: Stopping abusive conversions from chapter 13

The CLLA SUPPORTS the proposed amendment to Section 348(f)(1) of the Bankruptcy Code. This appears to codify existing practice and case law.

Section 128: Restraining abusive purchases on secured credit

The CLLA SUPPORTS the proposed amendment to Section 506 of the Bankruptcy Code. This provision is intended to address the situation where there is depreciation of an asset within a relatively short time of filing of bankruptcy by an individual. When filing occurs within 180 days of acquisition, the debtor is to assume the burden of the depreciation and would be required to pay the full outstanding balance. While the CLLA had some concern about the arbitrariness of the time period, it nonetheless supports the concept to shift the responsibility to the debtor in such situations. A similar responsiblity would be placed on the debtor in a subsequent case filed within two years of the date of filing of the original petition in bankruptcy.

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Section 129: Fair valuation of collateral

The CLLA OPPOSES the proposed amendment to Section 506(a) of the Bankruptcy Code. The proposal puts the creditor in a better position with a debtor in bankruptcy than a regular retail customer. This enhances the claim of secured creditors in a Chapter 7 and 13 for individual debtors. The CLLA believes that any standard should take into account the hypothetical cost of marketing and sale. To do otherwise is punitive to individual debtors.

Section 130: Protection of holders of claims secured by debtor's principal residence

The CLLA SUPPORTS the amendment to Section 362(b) of the Bankruptcy Code. This would allow for the delay or continuance of a prepetition foreclosure or sale without such act of contination or postponement triggering a violation of the automatic stay.

Section 141: Debts incurred to pay nondischargeable debts

The CLLA SUPPORTS the amendment to Sections 507 and 523(a) of the Bankruptcy Code. This provision would grant the same priority and nondischargeable attributes to a claim that represented payment for a debt that had a higher priority and nondischargeable status. While this provision is eminently fair in concept, it may provide some significant challenges in terms of proof in tracing charges and payments.

Section 142: Credit extensions on the eve of bankruptcy presumed nondischargeable

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The CLLA has some CONCERNS about this provision and believes that it may be overly expansive. This also would shift the burden to proceed from the creditor to the debtor through an adversary proceeding. The fact that the debtor has significantly limited funds to proceed would have a chilling impact on actions to rebut the presumption. An alternative approach that would be fair to debtors but still addresses the concerns of creditors would be a two pronged approach:

(i) shorten the time period for the rebuttable presumption to 30 days

(ii) increase the time period for luxury goods under Section 523(a)(2)(C) to 90 days

Section 143: Fraudulent debts are nondischargeable in chapter 13 cases

The CLLA SUPPORTS the provision to amend Section 1328(a)(2) of the Bankruptcy Code. This represents sound public policy.

Section 145: Credit extensions without a reasonable expectation of repayment made nondischargeable

The CLLA SUPPORTS the provision to amend Section 523(a)(2) of the Bankruptcy Code. It is only fair that debts not be dischargeable when they have been incurred where there is no reasonable expectation of repayment. However, issues of proof will abound and therefore absent a codified standard will negate the effectiveness of this provision.

Section 161: Giving debtors the ability to keep leased personal property by assumption

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The CLLA SUPPORTS the provision to amend Section 365 of the Bankruptcy Code.

Section 162: Adequate protection of lessors and purchase money secured creditors

The CLLA SUPPORTS the provision to add new Section 1307A to the Bankruptcy Code.

Section 181: Exemptions

The CLLA SUPPORTS the provision to amend Section 522(b)(2)(A) of the Bankruptcy Code. This would increase the period that an individual must be domiciled in a state from 180 days to 365 days in order to take advantage of a particular state's exemption scheme. This is a worthwhile attempt to at least make it more difficult for a debtor to exemption shop.

CONCLUSION

The CLLA generally believes that many of the consumer specific provisions contained in H.R. 3150 will benefit creditors and as detailed above should be enacted into law.

The Commercial Law League of America will also be providing written testimony on the business oriented provisions of H.R. 3150 in a separate document at a later date.

The CLLA is available to provide additional input as requested by the Subcommittee.

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Mr. **GEKAS.** Thank you very much. We now note the attendance of the Gentleman from Massachusetts, Mr. Meehan, the gentleman from Tennessee, Mr. Bryant, and the gentleman from Ohio, Mr. Chabot.

With that, we'll turn to Judge Donald.

STATEMENT OF HON. BERNICE B. DONALD, JUDGE OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TENNESSEE

Ms. **DONALD.** Chairman Gekas, members, let me thank you for allowing me to come this morning and give brief testimony. I will say at the outset that I am here in my individual capacity. I'm not representing any entity this morning. I would further state that I am much more experienced at imposing time deadlines than I am with complying with them, but I am going to endeavor this morning to stay within those guidelines and, certainly, be responsive to any questions that you might have.

Let me say, for fear that I will run out of time, that there are four points that I want to stress. First of all, all of my comments are going to be based, in large part, on my experience as a bankruptcy judge.

The one thing I want to say is that in reviewing the legislation, I believe that it is highly likely that it will overburden the bankruptcy courts, and will result in higher costs of administration, and higher costs imposed on the end-users of the system and the requirement for additional judges. I also believe that it will result in more people being placed in the position of resorting to pro se filings, which cause their own problems in the bankruptcy system.

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I know that the means-testing that is set out in the bill is designed to accomplish some well-stated goals. However, I believe that, in the final analysis, it is going to prove troublesome for the overall system. I believe that it will have the effect, as I said before, of driving up those costs and further complicating the system. I know that it has been said that many people will be exempted from that process because they will not meet the threshold guidelines, but I believe that even though the means-testing will not apply to everyone across the board, all of the other creditor-driven provisions will, in fact, apply to all of the debtors and therefore will result in a disproportionate impact on the poorest of the poor.

When I came to the bankruptcy court in 1988 in our district, which has a very high percentage of chapter 13 cases. There were three judges and we had some 11,000 bankruptcies that year. When I left in 1996, we had well over 17,000 bankruptcy filings. So, I have to concede that the rate has been growing and, I think, no one would doubt that.

But, the people that I saw coming before the bankruptcy court were not the traditional frauds, and cheats that we've talked about nor were they people who tried to manipulate the system. I saw people coming into the bankruptcy court as a result of, in many instances, very difficult circumstances. They were people who were in bankruptcy as a result of having gone through failed marriages and other traumatic family relationships. They were people who were at the outset either marginally employed or they were underemployed. Many people had an interruption in employment which resulted in their being unemployed, or they had illnesses or other catastrophies and they had to look for ways of dealing with those situations.

Many people were in bankruptcy because of a lack of planning or poor planning and the inability to understand the process of budgeting or poor savings practices. But, there were a myriad of things that landed people in the bankruptcy courts. I dealt with people from all across the spectrum, those who were well-educated to those who where persons of limited education. But in the final analysis, I found that while people were there in those very different capacities, the system had the capacity to deal with those citizens whatever their circumstances.

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Why do I say that? I acknowledge, as I said before, that there are people who attempt to manipulate the system, but by and large, those are not the primary people that we see in the system. We have in the bankruptcy law as it stands, provisions under Section 727, to deny a general discharge to people who are "frauds or cheats." We have 18 exceptions under Section 523 that allows the court the opportunity to except certain debts from discharge. And, I believe that the

presumptive nondischargeability provisions of the new legislation are going to be problematic and really drive up the costs of litigation. I think that with these presumptive nondischargeability provisions, we're putting creditors, such as former spouses and people who are trying to collect child support payments, at the same level with people who are trying to rush and collect credit card debt. I believe that the provision, Section 109, which prohibits successive filings gives courts tremendous abilities to deal with the differentiated problems that land people before the court. Section 707(a) provides the court the ability to dismiss cases for "cause" if we find that people are improperly accessing the system.

Finally, I believe, and I state in my written proposal, that there are many ways that we can strengthen Section 707(b) to deal with many of the very problems that you've indicated are of concern to you. I believe that reform is good and there's some reform that's necessary, but I don't believe that this present situation calls for the kind of drastic and radical reform that I believe is evidenced by the proposals before the Congress. And, as I say and will further comment on in the questions, I hope, that we can use Section 707(b) to tighten up some of those things and get at your concerns.

Thank you, Chairman.

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[The prepared statement of Hon. Bernice B. Donald follows:]

PREPARED STATEMENT OF HON. BERNICE B. DONALD, JUDGE OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF TENNESSEE

IS THE "MAJOR OVERHAUL" OF THE CONSUMER BANKRUPTCY LAWS PROPOSED BY THE SO-CALLED "NEEDS-BASED" SYSTEM UNDER H.R. 2500 AND H.R. 3150 ACTUALLY NEEDED OR WILL A "FINE-TUNING" OF SECTION 707(B) SUFFICE INSTEAD?

Mr. Chairman and distinguished members of this subcommittee, I am honored to have been invited to testify before you regarding an issue of fundamental importance to the American People—Bankruptcy Reform. This issue is of great concern and vital importance because it goes to the very core of our social and economic fabric. Just as it was an issue which was acutely important to the founders of this country and the framers of the Constitution, it is important today, and should be approached with careful and sober deliberation.

Before I get into my prepared remarks, let me state that currently I am a judge of the United States District Court for the Western district of Tennessee since January 1996. Prior to that time, I served as a judge of the United States Bankruptcy Court for the Western District of Tennessee from 1988 to 1996. During my tenure as a Bankruptcy Judge, I presided over Bankruptcy cases for individuals and businesses, large and small. When I became a Bankruptcy Judge in 1988 there were a total of 3 judges on our court and bankruptcy filings for that fiscal year totaled 11,545. By the end of 1995 we had four judges on the court and our filings totaled 17,736. At the close of 1997, the bankruptcy filings totaled 23,837 (See Exhibit 1). With the growth in bankruptcy filings, it is important to review the system, to evaluate how well its working, and to make charges where needed.

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I submit to you, based on my 7 1/2 years experience as a bankruptcy judge, that the system works, that the needs of debtors and creditors are being met, that while there are some instances of abuse, they are the exception rather than the rule and further they should not be tolerated; that there are sufficient mechanisms in the Code to address the problems, and finally that no radical reform is needed! Moreover, I submit that the drastic reform proposed by the current legislation will be highly injurious to the bankruptcy system for the reasons set forth herein.

Prior to 1984 the consumer finance industry was completely unsuccessful in its legislative attempts over the years to enact a threshold eligibility test to determine whether consumer debtors were entitled to relief under the bankruptcy laws. In 1983–1984 creditor groups made another run at a threshold eligibility test for relief under chapter 7, utilizing

in large part for support, the controversial findings of a widely-publicized 1982 "Purdue Study" that was funded by the consumer finance industry. The Purdue study found that a significant percentage of chapter 7 debtors had the ability to repay a meaningful portion of their unsecured, nonpriority debts under chapter 13 repayment plans. The study was later revealed, however, to be somewhat flawed and alarmist.

Although the consumer finance industry was not successful in 1984 in obtaining its desired threshold eligibility test for debtor relief under chapter 7, a legislative compromise resulted in the passage and enactment of section 707(b)—referred to as the substantial abuse section—which restricted unfettered access to relief under chapter 7. That is, restriction to relief under chapter 7 to avoid misuse of the bankruptcy laws by consumer debtors was accomplished by a judicial process utilizing the "substantial abuse" test of section 707(b). The legislative history underlying section 707(b) is confusing and ambiguous. Cong. Rec. H7489 and H7499 (daily ed. June 29, 1984). Section 109(g) also was enacted in 1984 to further restrict debtor relief in order to control abusive multiple filings by some debtors.

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If the court finds a "substantial abuse" as contemplated under section 707(b), the court dismisses the chapter 7 case or the debtor has to voluntarily convert the chapter 7 liquidating case to a repayment case under chapter 13 in the event the debtor seeks to obtain relief under the Bankruptcy Code. As a result, section 707(b) does not directly establish a mandatory or involuntary chapter 13. As a practical matter, section 707(b) does dictate in many cases the individual consumer debtor's choice of relief under the Bankruptcy Code: either chapter 13 relief or no bankruptcy relief at all. Section 707(b), however, does not contain a threshold eligibility test.

In 1997 the consumer finance industry made another run for a threshold eligibility test in chapter 7 cases. See H.R. 2500, the "Responsible Borrower Protection Act;" see also H.R. 3150, the "Bankruptcy Reform Act of 1998;" and compare S. 1301, the "Consumer Bankruptcy Act of 1997." This time around, the creditor groups are once again armed with a self-funded and fundamentally flawed report (i.e., the October 6, 1997 Credit Research Center Report). The defects in this report have been detailed by the United States General Accounting Office, pursuant to a bipartisan request for review.

The most recent sought-for threshold eligibility test for relief under chapter 7 by the creditor groups is cloaked with a buzzword phrase—"needs-based" bankruptcy system, whereby a consumer debtor ostensibly would be limited to the relief under the Bankruptcy Code that was actually "needed" under the circumstances. The needs-based system suggests to the public and members of the Congress that a flexible "tailor-made" non-judicial formula would be applied on a case-by-case basis to measure the exact amount of relief that was "needed" by a particular debtor. Actually there are only three options: no relief, relief under chapter 7, or relief under chapter 13.

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To determine the debtor's ability to repay and, therefore, which chapter for relief is "needed," the creditor groups further advocate a "means-testing" concept to accompany the needs-based bankruptcy system. This means-testing concept establishes a rigid, non-judicial statutory formula that is defined and strongly supported by the self-interested creditor groups. If enacted, this proposal would entirely replace and remove the independent and impartial court from the deliberative part of the eligibility process under section 109(b) in chapter 7 cases.(see footnote 8) Although determining eligibility for relief under chapter 7 of the Bankruptcy Code is a statutorily imposed duty of the court, the creditor groups propose to relegate this critical function to a non-judicial officer (e.g., a clerk, panel trustee, United States trustee or bankruptcy administrator, or other government bureaucrat) at the instance of creditor groups.

In essence here, one party to a court procedure seemingly is attempting to write the rules governing access to the court by another party. The very nature of this controversial, non-judicial formula, perhaps simple at first blush, will, among other things, definitely increase the workload of the court and make bankruptcy more intimidating and expensive for deserving debtors. It should be emphasized that the great preponderance of consumer bankruptcy cases do not involve high-profile celebrities and high-income debtors. Many statutory safeguards currently exist to protect creditors from dishonest and manipulative debtors and also to uphold the integrity of the bankruptcy system. See, for

example, 11 U.S.C. 727(a)(1) through (10), 523(a)(1) through (18), 1324–1325, 109(g), 707(a) and (b), 1307(c), and 18 U.S.C. 152.

I am mindful that the "needs-based" system advocated in H.R. 2500 and H.R. 3150 has the powerful backing of well-funded creditor groups and also certain members of the Congress. This concept essentially provides, as articulated by the creditor groups, that if an individual consumer debtor has the ability to repay unsecured, nonpriority debts and could thereby make meaningful payments under a chapter 13 plan, relief under chapter 7 should be denied. As noted, if such a debtor has the ability to pay and seeks relief under the Bankruptcy Code, the debtor would have to do so under chapter 13 or, simply stated, no relief would be available under the Bankruptcy Code as the chapter 7 case will be dismissed for lack of eligibility under section 109(b) based on H.R. 2500 and H.R. 3150 or dismissed as a substantial abuse under section 707(b) based on S. 1301. I submit that would potentially lend to some unprincipled results which are anachronistic to fundamental bankruptcy law.

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It may be said that a de facto needs-based system under the federal bankruptcy laws already exists, but without the rigid, non-judicial "means-testing" formula proffered by the self-interested creditor groups. See, for example, *In re Green*, 934 F.2d 568, 572–573 (4th Cir. 1991), which adopted a totality of the circumstances test as the proper analysis for determining whether a chapter 7 case should be dismissed for a "substantial abuse" under section 707(b) and stated that the bankruptcy court should apply the five following factors:

(1) whether the bankruptcy petition was filed because of sudden illness, calamity, disability, or unemployment;

(2) whether the debtor incurred cash advances and made consumer purchases far in excess of his ability to repay;

(3) whether the debtor's proposed family budget is excessive or unreasonable;

(4) whether the debtor's schedules and statement of current income and expenses reasonably and accurately reflect the true financial condition; and

(5) whether the petition was filed in good faith.

Compare *In re Krohn*, 886 F.2d 123, 126 (6th Cir. 1989); also compare *In re Walton*, 866 F.2d 981, 985 (8th Cir. 1989); *In re Kelly*, 841 F.2d 908, 915 (9th Cir. 1988).

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Sections 707(b) (substantial abuse) and 109(b) (eligibility for relief) are quickly becoming major battlegrounds in the Congress. In reality, the creditor groups once again seek a threshold eligibility test in chapter 7 under the guise of a "needs-based" bankruptcy system combined with a "means-testing" concept; however, this time around they also want to take the court out of the process to determine eligibility for relief and instead replace the court's independent and impartial rulings with a rigid, creditor- defined administrative or non-judicial formula—the so-called "means-test"—to determine whether chapter 7 or 13 is available to the debtor and concomitantly how much the debtor can repay over a five year period under a chapter 13 plan. Additionally, in 1997 and 1998 the cries of the creditor groups are much louder, extreme, and more sophisticated; they are better funded; and they are exceptionally well organized with high powered lobbyists (e.g., Lloyd M. Bensten, Haley Barbour, and Lloyd Cutler) and have launched massive and extensive public relations and media campaigns.

Notwithstanding the self-serving position of the creditor groups, there are no real compelling reasons in 1998 to "rush to legislate" consumer bankruptcy reform. Balance, patience, careful deliberation, and independent thinking are vital. Careful consideration of the needs and concerns of both debtors and creditors are warranted. The proposed needs-based bankruptcy system to determine whether relief should be granted under chapter 7 or 13, with its accompanying non-judicial "means-testing" concept or formula to determine a debtor's ability to pay, should be

rejected at this time by the Congress in favor of more thoughtful, equitable, and balanced consumer bankruptcy legislation.

Instead, certain "fine-tuning" amendments to existing section 707(b) will suffice that will maintain the carefully created statutory balance between the interests of debtors and creditors. For example, section 707(b) could, and should, be amended (i.e., "fine-tuned") by:

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striking the requirement that debtor abuse be "substantial" before the court may dismiss a chapter 7 case (a "zero tolerance" standard should be adopted);

inserting "ability to pay" as a statutory factor that the court must consider along with the totality of other relevant factors (e.g., the five *Green* factors enumerated above, among others);

eliminating the distinction between a debtor's consumer and business debts; (i.e., 707(b) does not apply to business debts)

striking the phrase "but not at the request or suggestion of any party in interest;"

broadening the standing requirement to include panel trustees and also any creditor in a particular case that has made written demand upon the United States trustee or bankruptcy administrator to file such a motion and the United States trustee or bankruptcy administrator thereafter declines in writing to do so; or alternatively allowing a creditor after written denial by the U.S. trustee, to obtain review of such denial by virtue of Bankruptcy Rule 2020.

allowing recovery of actual damages, including costs and attorneys' fees, and, in appropriate circumstances, punitive damages if creditors file section 707(b) motions with little or no basis in fact or law; and

providing that a section 707(b) motion shall not be dismissed or withdrawn at the creditor's instance without a court order and notice as the court may direct.

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Section 707(b) must be considered in combination with section 521(1), which requires a debtor to file a schedule of current income (Schedule I) and expenditures (Schedule J). After a line-item review of these schedules, currently the court, on its own motion, or on a motion by the United States trustee or bankruptcy administrator determines whether the debtor has excess income to pay off the debts or "has padded" his/her expenses to support "freewheeling spending" and a life of luxury.

The Bankruptcy Code strikes an equitable balance between the competing and countervailing needs and interests of all parties involved. With this "needs-based" and "means-testing" proposal, creditor groups are attempting to disturb this delicate statutory balance. The Congress recognized the equitable balancing of such needs and interests in 1984 when it passed sections 707(b) and 109(g) to avoid abusive practices by some consumer debtors. S. Rep. No. 65, 98th Cong., 1st Sess. 43 (1983) (Senate Report accompanying section 445, Omnibus Bankruptcy Improvements Act of 1983). Although the legislative history underlying section 707(b) reveals that this limited standing requirement precludes "creditors from making bankruptcy too expensive for the debtors by filing harassing motions alleging substantial abuse," 130 Cong. Rec. S7624–S7625 (daily ed. June 19, 1984), there is no compelling reason why creditors should not be allowed to file motions under section 707(b) provided that they have made demand in writing on the United States trustee or bankruptcy administrator and the United States trustee or bankruptcy administrator thereafter declines in writing to do so. The enlarged standing under section 707(b) could assist the courts since when raised sua sponte, the court becomes both an advocate and a judge in those cases where the United States trustee or bankruptcy administrator has failed to properly act.

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Harassing or other non-meritorious section 707(b) motions and overreaching by certain creditors to extract reaffirmation agreements should be strongly discouraged. The abusive, aggressive, and improper reaffirmation practices used by Sears, Roebuck and Co. (and others) to persuade debtors to pay discharged obligations are now widely known. Abuse by creditors (or debtors) should not be tolerated. See H.R. 3146, the "Consumers Lenders and Borrowers Bankruptcy Accountability Act of 1998," introduced on February 3, 1998. According to the introductory statements made on February 3, 1998, by Rep. Nadler (D-NY), sponsor of H.R. 3146, the bill is aimed "at reforming the bankruptcy system by targeting both debtors and creditors whose irresponsible and sometimes dishonest behavior has undermined public confidence in the fairness of the bankruptcy system and has cheated honest debtors and creditors."

House Report No. 3146 attempts to balance the competing interests of both debtors and creditors. It would:

prohibit wealthy borrowers from shielding assets by buying expensive homes which can be fully protected from creditors under an unlimited homestead exemption available in certain states;

provide a carefully targeted mechanism to prevent debtors who can afford to pay from escaping their debts in bankruptcy;

increase incentives for debtors to voluntarily pursue a chapter 13 payment plan;

educate debtors to improve their understanding of alternatives to bankruptcy;

discourage lenders from making new loans to consumers who are already overloaded with debt;

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make lenders that provide credit to compulsive gamblers in casinos responsible for their conduct;

encourage lenders to work with financially strapped consumers who are making their best effort to arrange a payment schedule; and

penalize creditors that violate the limits which bankruptcy places on coercive collection practices.

Indeed, ways to fairly advance and improve the actual and perceived integrity, accountability, and the efficiency of the bankruptcy system free of abuse should be the goal, while maintaining an equitable balance of the competing and countervailing interests of both debtors and creditors. There has been no demonstration that a "major overhaul" of the consumer bankruptcy laws and system is needed. Instead, with fine-tuning amendments to section 707(b), as suggested above, the Congress will continue to delicately balance the needs, responsibilities, and interests of both debtors and creditors and also further the actual and perceived public confidence in the bankruptcy system.

CONCLUSION

I applaud Congress for its efforts to make sure that we have the best bankruptcy system possible. Further I applaud Congress for its willingness to undertake reform where needed, but I hope that Congress will be equally willing to exercise restraint, and refrain from imposing radical reform on a system that is working remarkably well. Yes some change is needed, but the reform needed is only "fine-tuning!" Radical reform is not warranted as is demonstrated by the GAO Report and other data generated by the system.

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Is there abuse in the system? Yes. There is some abuse. There are debtors who misuse and manipulate the system and file bankruptcy for improper purposes, just as there are creditors who abuse the system. Yes, there are certain high

profile debtors, certain celebrity debtors or debtor athletes who have used the system for unintended purposes and make a mockery of the system. Such examples are outrageous! But these examples are a miniscule part of the total system; they are microscopic in comparison with the millions of debtors who have used the system for its intended purposes—to get a breathing spell, to get a fresh start, to preserve assets and in the process preserve integrity, dignity and hope!

The system, with a little fine-tuning, can deal with those issues of which Congress is concerned, but we can ill afford to formulate policies or to legislate based on extremes or aberrations.

If the current legislation is passed, the weight and cost of that legislation will be born disproportionately by the poorest of the poor, the people who are most deserving or relief, the people who can ill afford to have courthouse doors closed to them. Additionally, if passed, the legislation will drastically drive up to cost of filing and administering bankruptcy, will overburden the courts which will have to hold hearings and litigate the myriad of issues raised by he litigation, and ultimately require more judges.

I strongly urge Congress to carefully and fully consider more independent data in evaluating the impact of the legislation on the system.

I again state the system is not broken, it works reasonably well. It only needs a "tune-up" and not an "engine-overhaul."

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Thank you for permitting me to testify. I ask that my entire statement be admitted for the written record.

Mr. **GEKAS.** I thank the judge.

Five minutes for the first round of questioning. Judge Donald, you don't believe that the unemployed person who has no source of income would not find safe haven in the precepts of H.R. 3150, do you?

Ms. **DONALD.** I believe that that person who is unemployed may very well find some of the provisions in there to be a barrier to actually assessing the court and obtaining much needed relief. I don't see where that individual is helped at all because, even the unemployed person, if they have, for example, some consumer debt, if that consumer debt was incurred within, say, 90 days of bankruptcy, that is going to be presumptively nondischargeable. That person who's unemployed certainly is going to be in a very poor position to come into court, as someone said earlier, and litigate those issues. So, I believe the proposed legislation would not provide a safe haven.

Mr. **GEKAS.** If we applied the standard, the unemployed person does not have 75 percent of the median established by the country. Presumably, he is ready for chapter 7.

Ms. **DONALD.** Well, that person may be ready for chapter 7, but that person may also have some other kind of income that might allow them to go into 13, for example, and preserve certain assets that 7 might not allow them to do.

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Mr. **GEKAS.** If he would choose so, you mean?

Ms. **DONALD.** Certainly.

Mr. **GEKAS.** We don't bar that. The choice is still with the debtor. But, anyway, we'll take into account what you've said. Ms. Miller, under your critique of section 141, you said that one of the flaws is that there's no time limit. Is that correct?

Ms. **MILLER.** There are no time limits in this section, as proposed, and, ultimately, the success of being able to recover for an unsecured creditor is its ability, if it has advanced funds, to trace those specific funds as having been used to pay a nondischargeable or priority obligation.

Mr. **GEKAS.** How should we apply the time limit?

Ms. **MILLER.** I'm not certain, at this point, we have a recommendation, per se. It was merely an observation, and not——

Mr. **GEKAS.** Well, if you can dredge one up, submit it to us as a recommendation——

Ms. **MILLER.** We will be happy to address——

Mr. **GEKAS.** Because that's a serious concern.

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Ms. **MILLER.** We will be happy to address it, and I'll get back to you with it. In some ways, maybe a time limit may or may not be necessitated, but the further away you get, the more difficult the tracing problems will be and the less likely someone will be able to step into the shoes of the nondischargeable creditor.

Mr. **GEKAS.** All right. Thank you. Mr. McDonnell, you said something very interesting, and without knowing it, you supported one of the theses which I personally have been advocating to try to achieve bankruptcy reform, and that is that one of the costs to the general public, to our country, to the consumers, to taxpayers, to everyone, is the rising interest rates that can come about because of all the bankruptcies that are occurring. You stated that in your enterprise, in 1997, prevailing interest rate might have been reduced had it not been for the overwhelmingly number of bankruptcies that occurred among your members. Is that correct?

Mr. **MCDONNELL.** Yes sir. On our consumer loans, we computed it would have reduced the rate by 50 by 130 basis points, and on our credit card, which is as I mentioned, twelve and one half percent, we could have reduced that rate by 130 basis points.

Mr. **GEKAS.** Thank you very much. That's very pertinent to what some of us have been saying. And, Mr. Banks—I can't read my writing. Well, I'll have to submit my questions to you in writing if I can interpret my writing.

Mr. **BANKS.** I'd be honored.

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Mr. **GEKAS.** All right. Thank you. And, Ms. Starr, your recommendation is that we should be adding to the punitive portions of fines and penalties. Is that it?—instead of just the sanctions that we have. Did you say that you would like to see the law enforcement portion strengthened by the imposition of fines and penalties?

Ms. **STARR.** I was referring, Mr. Chairman, to the nondischargeability provisions and suggesting that the current language in the bill chips away at the super discharge by ensuring that fraud debts are nondischargeable under 13, as they are in 7, and in individual 11s. We are suggesting that fines, penalties, and forfeitures, which are also currently nondischargeable on individual 11s and 7s should also be nondischargeable on 13.

Mr. **GEKAS.** Thank you very much. The Chair now yields to the gentleman from New York for 5 minutes.

Mr. **NADLER.** Thank you, Mr. Chairman. Mr. McDonnell, you mentioned a moment ago that, if we had this kind of bankruptcy reform and you had therefore more recovery on debts, your credit card interest rates would go lower from maybe 50 bases points to twelve and one half to twelve percent. We've had deregulation for the last 18 or 19

years now, and we were told when deregulation was first being legislated, that we had to deregulate credit card interest rates because you couldn't have a 6 or 7 percent limit at a time of 17 percent inflation. So, they'd go up to 18 or 19 percent. When inflation came down, when the prime rate came down, when the cost of money came down, the credit card interest rates will come way down. Yet, we now find that the average credit card interest rate is 16, 17, 18 percent, not in credit unions, but with the big card issuers. Some cards I've seen—the biggest card issuers, yes, they were Colby National Bank, that no one ever heard of, may have a cheap card, but the big banks are all 19, 21, 22 percent. And, the spread on these cards with the cost of money at 8 percent, is absurd. We find the credit cards are the biggest profit centers for the banks, and they're losing money on east Asia. Why do you assume that the big banks would lower credit card interest rates just because their expenses went down when the history of the last 20 years tell us they won't, and that banks act like oligopolies.

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Mr. **MCDONNELL.** Mr. Nadler, I'm not here to talk for the mass credit card issuers. I'm here to talk for credit unions, and on average our——

Mr. **NADLER.** What percent of credit cards in this country are issued by credit unions?

Mr. **MCDONNELL.** Well, we have 540,000 outstanding Visa cards. I don't know what percent the credit card industry has, but I would imagine credit unions are pretty small because we only have 3 percent of the total——

Mr. **NADLER.** And, so, what you're saying is—so your testimony is that we should take substantial rights away from debtors in order to get a very small percentage of credit card interest rates be lowered.

Mr. **MCDONNELL.** I'm saying, you should not treat all creditors the same way. You have to have some balance in terms of the approach that you take on all of this bankruptcy legislation.

Mr. **NADLER.** Thank you. Judge Donald, you mentioned that many debtors are in bankruptcy because a debtor has poorly managed his funds or her funds. How would making credit card run-up, a run-up of credit card debts, 90 days pre-petition, nondischargeable, effect such a debtor.

Ms. **DONALD.** Well, I think, what that does, I don't think it helps the debtor at all manage the debt because I don't think that most people go into this process with a front end desire that they're going to run up the debt and then run to court to get a discharge. But, there are some that, I'm sure, would heap up debt before bankruptcy and the existing law is designed to deal with that adequately.

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The comment I wanted to make before was that I believe that the presumptive, nondischargeability provisions of the new law, basically, frustrates the fundamental fresh start that the law is designed to accomplish. And, that has been, I think, a fundamental goal of bankruptcy since the beginning.

Mr. **NADLER.** How would this affect the unsophisticated debtor who, 80 days before he finds himself forced to file for bankruptcy, shifts debts from 18 or 19 percent credit cards to a teaser 6.5 or 5.9 percent credit card, specifically to try to avoid bankruptcy, and not realizing that 3 months later, it's going to go back up to 19 or 22 percent? And, this would make this all nondischargeable, wouldn't it?

Ms. **DONALD.** It would. And, I think it would penalize a debtor who was actually trying to do the right thing because of difficult circumstances, it would get that person, basically, hung because then the person would have to go into court and try to rebut the presumption, because the debt would be presumptively nondischargeable. The person would have to go into court and litigate whether or not they reasonably believed that they had the ability to repay that debt. All of these issues would be laid before the court and would be a source of litigation driving up costs thereby providing a boon for lawyers and requiring more judges.

Mr. **NADLER.** Yes. Thank you. I have one more question for you. H.R. 3150 proposes to narrow, substantially, the super discharge by adding several exceptions to the discharge in the chapter 13. How big an inducement to repay debts in chapter 13 do you think a super discharge is and do you think that curtailing it, as proposed in this bill, would have the affect of increasing or decreasing recoveries in bankruptcy?

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Ms. **DONALD.** I think restricting it, probably, Congressman, would have the ability of killing it or making it so weak as to make it ineffectual. In my district, as I said before, nationally, I think you have about 30 percent of people going into chapter 13. In our district, it's about 76 percent of the people in chapter 13, voluntarily and approximately 42% actual complete chapter 13. Nationwide, I think, the successful completion is somewhere around 30 percent, and ours is about 42 percent. I believe that the super discharge probably is one of the factors that makes chapter 13 attractive and I think restrictions and limits on the super discharge probably would have a chilling effect.

Mr. **NADLER.** So, would it increase or decrease recoveries in bankruptcy if we were to restrict it, do you think?

Ms. **DONALD.** I think if you restrict it, it probably would decrease recoveries because I don't know that you'd have as many people going into chapter 13. But, let me say that I would—I would really want to defer that to some of the judges who are dealing with these issues day to day. It's been 2 years since I've actively served and so many of my comments are based on my experience when I was actively sitting. I know that I have a bankruptcy judge who's here who's dealing with day to day bankruptcies who would much better be able to respond, specifically, to your question and predict those trends.

Mr. **NADLER.** Thank you very much.

Mr. **GEKAS.** I turn to the gentleman from Tennessee, Mr. Bryant.

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Mr. **BRYANT.** Thank you, Mr. Chairman, and I want to welcome this panel and especially welcome the outstanding jurist from part of my district—the Western District of Tennessee. A judge, whom I've had occasion to practice before, in my other life, and a judge whose opinion I greatly respect, who brings to this panel, not only her current status as a United States district court judge, but as she alluded to earlier, quite an in-depth experience as a bankruptcy—as one of the bankruptcy judges in the Western District of Tennessee. I am encouraged by your comments that the current Code, particularly section 707, can be, in your view, reformed, perhaps substantially, to address this issue of abusive filings. It's certainly the alternative—the method in the Chairman's bill which addresses it in another way, and I certainly want to review, very carefully, what, I understand, is in your written statement and perhaps other proposals. And, thank you for testifying.

Ms. **DONALD.** Thank you, Congressman Bryant.

Mr. **BRYANT.** Mr. McDonnell, just a couple of questions for you regarding the credit union. I understand you represent the Naval credit union and—I think it was a witness from last week in a similar hearing, who testified of, I forget the exact numbers, but of real substantial losses that credit unions suffer as a result of bankruptcy. I think, one half of the losses that credit unions suffer annually are from bankruptcy filings. And, I know in your statement, you indicate that your particular credit union has a relatively high amount, of charge-offs each month, from two to, I think, four million dollars a month——

Mr. **MCDONNELL.** Yes sir.

Mr. **BRYANT** [continuing]. From bankruptcies. And, I know the credit union used to be a very careful credit selector. You're very careful in whom you screen to loan money to. Probably, in any financial institution we've got, you

guys are the best, and yet, you still face these losses through bankruptcies. How can you explain this?

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Mr. **MCDONNELL.** Well, first of all about our losses. Last year they were $40 million, and $26 million of that total was due to bankruptcy. So, that's roughly the ratio. I also mentioned that a lot of the bankruptcy charge-offs were attributable to younger members declaring bankruptcy. The average age last year was 32. And, I don't know if you saw a lot of the articles that appeared in the Washington Post lately about the state of the financial affairs within the Navy community. I think they indicated clearly the loss of the social stigma associated with bankruptcy at this time. A lot of people are looking for the easy way out, and I think, that's being reflected in the statistics of our credit union, as well as many others. When you ask about looking at credit, we disapprove about 35 percent of the requests we get for consumer credit. We take a very paternalistic view point when it comes to credit. We make sure that the member can afford it. There are also changes in circumstances that occur, like the judge was referring to, marital difficulties, and so forth. I would say in the case of bankruptcy probably 85 to 90 percent is warranted. In other words, there actually is a bona fide need. But, you have the 10 to 15 percent that we're concerned about and that makes up a large dollar amount.

Mr. **BRYANT.** Well, to me, just trying to think through this issue on both sides, and trying to be as objective as I can, it seems to fly in the face that easy credit is the cause of bankruptcy because you folks are facing the same problem, too. Let me quickly ask you another question because I know you all are out front on this issue of trying to educate folks on how to avoid bankruptcy and things that we're talking about in this bill—some consumer information—has that been helpful?

Mr. **MCDONNELL.** Yes, it's been helpful to an extent, but the number of members with financial difficulty is so large, it's very difficult to deal with. As I was mentioning, we have 2,000 families in our program right now and, of course, it's at no charge to them, and that number could go up considerably because of the state of the finances of our membership. I think, that we do a pretty good job in addressing alternatives in terms of our debt counseling and receivership program, where we actually take the pay of the individual and prorate it with creditors. But, even so, the numbers are kind of overwhelming. I think, one of the things that could be done by Congress, is to require some kind of debtor education up on the front end by the lawyers or whoever else is involved in the front end process, because what's actually happening is the younger people are being hurt. They're going into bankruptcy without being advised of the alternatives, and I think, they're being hurt because when they come back in the market, they can't get credit from, what I call, responsible creditors anymore.

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Mr. **BRYANT.** Thank you. Thank you, Mr. Chairman.

Mr. **GEKAS.** I turn to the gentleman from Massachusetts, Mr. Delahunt, for a round of questioning.

Mr. **DELAHUNT.** I defer to my senior colleague, of course, Mr. Meehan. My senior, both in terms of service, as well as——

Mr. **GEKAS.** I try to go——

Mr. **DELAHUNT** [continuing]. Chronologically, Mr. Chairman.

Mr. **GEKAS.** I try to go in order of appearance at the hearing, but you——

Mr. **DELAHUNT.** Out of due respect to Mr. Meehan—— [Laughter.]

Mr. **GEKAS.** Out of disrespect, then I—no due respect as to the gentleman, Mr. Meehan. [Laughter.]

Mr. **MEEHAN.** Thank you, Mr. Chairman, and out of disrespect, let me ask—no. [Laughter.]

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Mr. **MEEHAN.** First of all, Ms. Greenstone Miller, you argue against the so-called "fixed formula" for evaluating ability to pay under a needs-based approach to bankruptcy on the grounds that a fixed formula doesn't take into account what you say are the many variables that form the basis for why an individual files for bankruptcy protection. I just want to make sure that I understand your comments correctly. Are you saying that the fixed formula in H.R. 3150 is inadequate, but that, perhaps, a more comprehensive fixed formula would be acceptable, or are you saying that any fixed formula is necessarily unable to do justice to an individual debtor's particularized circumstances.

Ms. **MILLER.** I think it's the latter, that the League does not support a fixed formula very much for the same reason that Judge Donald spoke of. We believe the bankruptcy court is not only a factfinder, but a court of equity and is able to, on specific facts and circumstances, make appropriate determinations in a case. There are already triggers there that can be enhanced with respect to motions that would be filed by a party and interest suggesting that it was in the best interest of the creditors that, instead of the case being in a chapter 7 liquidation proceeding, that it should be in a chapter 13 proceeding. But, to have a fixed formula restricts the bankruptcy court and its ability to make determinations on a case by case basis, and therefore the League does not support any fixed formula at this point.

Mr. **MEEHAN.** Thank you. Judge Donald, you suggest that 707(b) should be amended to insert "ability to pay" as a statutory factor that the court must consider in determining whether chapter 7 filings are abusive. Do you think that this new statutory language should flush out precisely what constitutes ability to repay and, perhaps, in terms of ability to pay a portion of unsecured debt?

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Ms. **DONALD.** I believe that the ability to pay should be inserted, as I said before, as a necessary component for the court to consider. But while there should be guidelines, I think the courts must always be allowed to look at the totality of the facts and circumstances and be able to determine whether a person has the ability to pay. And, I think, that's one of the things that judges are uniquely trained to do, and that is, to exercise discretion and evaluating within certain prescribed guidelines. With all of its strictures, H.R. 3150 would still require the court to make these determinations after expensive litigation.

Mr. **MEEHAN.** I want to ask Mr. McDonnell a question. Among the many recommendations that—for consumer bankruptcy that the National Association of Federal Credit Unions is calling for, is the establishment of the Bankruptcy Advisory Council, including debtor and creditor representatives, the council would be associated with, at least under the proposal, with the Department of Justice, and would be charged with studying bankruptcy. Given the deep divisions on consumer bankruptcy issues that characterize the deliberations on both the National Bankruptcy Review Commission and, indeed, in this subcommittee, do you believe that a newly created council would achieve any significant degree of consensus on the merits and flaws of our bankruptcy system?

Mr. **MCDONNELL.** Yes, sir. I think there are two good examples of committees that have helped. One is the Thrift Institution Advisory Council and the other one is the Consumer Advisory Council. Both give advice to the Federal Reserve Board on issues, and they have pretty good balance among them. One of the problems we had with the National Bankruptcy Review Commission was it was weighed too heavily—and I hesitate to say this—on the side of lawyers—in terms of the representation. We think we'd get some pretty good balance if we were able to establish a committee along lines in which you had everyone represented.

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Mr. **MEEHAN.** Thank you and, Mr. Chairman, I just want to thank my senior junior colleague from Massachusetts for yielding to me first.

Mr. **GEKAS.** The gentleman from Massachusetts, Mr. Delahunt, is now recognized.

Mr. **DELAHUNT.** Yes. Thank you. Thank you, Mr. Chairman. And first of all—maybe to Mr. Banks. In 3 years, you went from about $25 to about $50 million in terms of losses. Is that your testimony?

Mr. **BANKS.** That's accurate.

Mr. **DELAHUNT.** Did you have a chance to do, or have you commissioned a follow up review or study to determine why there has been this significant increase in losses, just to provide us with a rationale for that significant increase?

Mr. **BANKS.** We certainly are interested and we'll try, but the figures I quoted to you are our bankruptcy losses. Now, at the same time they have been going up with that speed, our overall write off losses on loans have not reached that level—anywhere near it. It's hard for us to establish motivation as to why we're able to control our overall losses, but as a percentage of total losses, those that are in bankruptcy rise dramatically. We just don't have access to that kind of data. We have relatively small balances in the neighborhood of 200, 300, 400, 500, depending on our portfolio, dollar average balance. So, a debtor by debtor examination of those is difficult.

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Mr. **DELAHUNT.** I was very pleased to hear your testimony about your underwriting practices, in terms of assessing whether to extend credit or not. Is part of the problem possibly and, I think you alluded to it, the accessibility of current data to lenders to make a really accurate determination as to whether a particular customer, or debtor, is at risk.

Mr. **BANKS.** That is certainly part of the problem. The systems in place today are computers linked to those of consumer reporting agencies which do give us rapid access to much data with regard to the debtor's or the consumer's position with regard to outstanding credit. That's only as current as what has been reported to the bureaus and some ——

Mr. **DELAHUNT.** And, there can be a time lag there.

Mr. **BANKS.** Yes. And, on the other side, we have virtually no access to reliable sources of data about the debtor's income. You know, for instance, telling us that we need to do a debt to income test before we lend would put us in an impossible position. We just don't have access to that data.

Mr. **DELAHUNT.** Well, thank you, Mr. Banks and Mr. McDonnell, how many members do you have in your credit union?

Mr. **MCDONNELL.** One point seven million.

Mr. **DELAHUNT.** One point seven million. That's a substantial sized credit union.

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Mr. **MCDONNELL.** Yes, sir.

Mr. **DELAHUNT.** You are the first witness who has given an answer in terms of what the interest rate would be but for your losses—a hundred and thirty basis points, in terms of credit cards, and fifty basis points, in terms of your consumer loans. I have real reservations as to whether this might occur elsewhere because I would make the distinction, and would ask for your agreement, that you are owned by your members. You are a nonprofit organization. And, I think it's a fair statement to say that, in the course of the last decade or so, when interest rates, back in the mid-1970's, went to 18 and 19 percent, we haven't really seen a resulting drop, even though the cost of money clearly receded to, I think, it's about 8 percent now.

You know, in discussions I've had with credit unions in my own district, they talked about the need for credit cards as a significant profit center so that they could compete with larger banks. Is this your experience, too? If you didn't have it, you'd be in trouble.

Mr. **MCDONNELL.** Yes. Credit cards are a way of life today—debit cards, credit cards—it's the way of the future. You have to offer that convenience to your members.

Mr. **DELAHUNT.** Particularly when we see all kinds of mergers and consolidations going on in the banking industry. For credit unions to survive, and small community banks, to survive in this conglomerization, if you will, of banks, if you don't have—if you can't rely on your credit card as a significant profit center, your chances of competing are at risk.

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Mr. **MCDONNELL.** Yes. Of course, we look at things a little bit differently from the standpoint of a profit center.

Mr. **DELAHUNT.** Right. I understand.

Mr. **MCDONNELL.** We try to keep our rates down, and so forth, on credit cards.

Mr. **DELAHUNT.** And, that's why so many of us support credit unions——

Mr. **MCDONNELL.** Thanks.

Mr. **DELAHUNT** [continuing]. Mr. McDonnell.

Mr. **MCDONNELL.** Yes sir.

Mr. **DELAHUNT.** May I ask the indulgence of the Chair for one more question?

Thank you. You also talked about protecting debtors from creditors who gouge or mislead their consumers. You mentioned that in your opening statement. Could you expand on that and tell us what you meant.

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Mr. **MCDONNELL.** Well, on this subject of bankruptcy, I think there is a lot of guilt for everyone, on both sides of the equation. In the case of some of the B&C creditors, I call them, where they charge really high interest rates, and there mass mailers of credit card solicitations, I personally don't care for these practices myself, in terms of what it does for my kids or my members. Okay? And, so that's a factor that has to be taken into consideration. But, generally, if you go bankrupt on us, Navy Federal Credit Union, and you cause us a loss, when you're coming back into the market, you're not going to come to us and get a twelve and a half percent credit card rate. You're going to have to go elsewhere and get a much higher percentage rate on your credit card. And, that's what I meant.

Mr. **DELAHUNT.** Do you think some of these credit—these gougers, if you will, are really creating part of the problem in terms of the ability of the debtor to get out—to extricate him or herself—from a very bleak situation?

Mr. **MCDONNELL.** Like I said, there's a lot of guilt to go around. The bankruptcy lawyer advertisers, the mass credit card solicitors. The pendulum is just swinging too far on both ends, and that's what I'm concerned about.

Mr. **DELAHUNT.** Thank you very much.

Mr. **GEKAS.** Thank you very much. I would like to extend our special gratitude to all the panelists and, by your

presence here, you also have agreed that we could submit written questions to you at some later point.

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

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Mr. **GEKAS.** The gentleman from New York.

Mr. **NADLER.** Mr. Chairman, in view of the very important testimony of this panel, I would ask that we have another round of questioning so we can get some more information that we desperately need.

Mr. **GEKAS.** I will accord the gentleman another——

Mr. **NADLER.** I meant the entire panel. Whoever wants to. Thank you.

Mr. **GEKAS.** If the gentleman has requested it, I will grant it to him.

Mr. **NADLER.** Thank you. Thank you. First question to Judge Donald. When we make additional debts nondischargeable, as it's proposed in H.R. 3150, how does this affect the rights of other creditors of nondischargeable debts? For example, if we make credit card charges made in a 90 days pre-petition period nondischargeable, how would this affect the ability of a divorced mother to collect child support from the debtor, post-discharge? Would she have to compete with Visa for the debtor's post-discharge income?

Ms. **DONALD.** Absolutely. You are then placing the credit card issuer, and that creditor, on the same level as you are the former spouse or the mother who is trying to collect child support payments. And, I think you are also frustrating that equality of distribution that undergirds the bankruptcy system, and, perhaps, reinstituting that race to the court house, or the "grab for assets." That is a real concern of this legislation.

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Mr. **NADLER.** So, do you think that that would undermine—the public policy of the Congress to increase child support payments, collections? Would that be a result of this change?

Ms. **DONALD.** It absolutely does, Congressman Nadler.

Mr. **NADLER.** Thank you. We've also heard a great deal about abuses in the context of reaffirmation agreements. For example, in the Sears class action case, the company was found to have entered into numerous reaffirmations with debtors, without filing them with the court. In other cases, for example, in the case decided in the Eastern District of New York, In re: Bruzzese, I think it is, the court found that a debtor had reaffirmed the debt of $1,800 in exchange for $500 in new credit. The court calculated that this reaffirmation had an effective annual rate of 124 percent. My question is, in your experience as a bankruptcy judge, how widespread is this sort of abuse? Do you think if parties in interest are given additional opportunities to initiate litigation against debtors, as this bill will do in many respects, that coerced reaffirmations would increase? And, finally, if we allow ride through and recapitalization of arrears in chapter 7, can we avoid some of these abusive practices by simply eliminating reaffirmations entirely? In other words, what do you think would happen with this legislation with respect to reaffirmation abuses, and how prevalent is that now?

Ms. **DONALD.** I think that, with the legislation, certainly, the potential for coercive tactics to get debtors to reaffirm debt and pay for it out of post-petition income, is going to immensely increased. I have advocated a zero tolerance for abuse, and that means abuse by debtors and abuse by creditors, and I think that's something we legitimately have to be concerned about. And, I think that under this legislation, creditors would be encouraged, implicitly, by the legislation, to use whatever tactics that are reasonably available to try and get their debt satisfied ahead of other creditors. And, so, I think the scenario that you paint is one that is realistic and one that is very probable under the legislation, as it's currently drafted.

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Mr. **NADLER.** We should redraft the legislation to prevent that, I presume.

Ms. **DONALD.** Absolutely. Zero tolerance for abuse is the watch word.

Mr. **NADLER.** Thank you. Mr. McDonnell, do you think that the people who have been characterized as gougers should be given the same rights to share in the proceeds of the estate as a responsible lender, such as your credit union and its members?

Mr. **MCDONNELL.** I wouldn't know the answer to that, Congressman. I wouldn't know how to deal with it from the standpoint of how it could be dealt with in a practical sense. I would like to say, no, but it's a pretty shallow answer, because I don't know how it would be dealt with from a practical standpoint.

Mr. **NADLER.** But, if some standards could be drawn, and some distinctions made, do you think they should?

Mr. **MCDONNELL.** I would like to see that. Yes sir.

Mr. **NADLER.** Okay. Thank you very much. Thank you, Mr. Chairman.

Mr. **GEKAS.** Does the gentleman from Tennessee require any more questioning? If so——

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Mr. **BRYANT.** I pass at this point.

Mr. **GEKAS.** The gentleman from—you did have some extra time, you know. That's charged against you.

Mr. **DELAHUNT.** I'll just——

Mr. **GEKAS.** You may proceed.

Mr. **DELAHUNT.** In terms of the questions that I had posed to Mr. McDonnell—if Mr. Banks—if he just has some observations. Do you have, or could you give us, an idea of what your interest rate would be, if you have an interest rate, how much it would have been reduced if those losses hadn't occurred. And the last question that the Ranking Member, Mr. Nadler, asked of Mr. McDonnell, if you'd care to comment on that, I'd like to have your impressions.

Mr. **BANKS.** I hesitate to say that I'm just a simple country boy from Iowa, and I don't have the financial background, the analytical skills, to tell you what our interest rates would be. Quite frankly, I don't know whether our response to improved bankruptcy performance would be wider availability of credit to those people who are responsible or whether it would be a lowering of our interest rates. I, honestly, don't know what the answer is to that. With regard——

Mr. **DELAHUNT.** Thank you for your honesty, Mr. Banks.

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Mr. **BANKS.** With regard to a bankruptcy code, taking into account the nature of the creditor or the nature of the credit that's out there, it strikes me that, if what is motivating that, is people's concern about abusive practices in lending, there ought to be a way other than the bankruptcy code for Congress to deal with those practices. I would prefer personally, seeing the bankruptcy code limited to providing fresh starts and equitable distribution of available wealth.

Mr. **GEKAS.** The gentleman from Tennessee——

Mr. **BRYANT.** Mr. Chairman, may I just briefly comment. Again, I apologize to this panel for coming in late. All of us have a schedule we have to keep with other committees. I'm not here to defend the credit card companies, but I do know, coming from the Western District of Tennessee, which for some reason or another has just, I've seen numbers this morning as high as 32 times the national rate of filings for bankruptcies. Now, I know we get solicitations for credit cards where I live, but we don't get that much, and we don't get that much additional credit—32 times the national average of credit, that that causes us to have that number of filings and bankruptcies. So, let's be fair about this. Let's—don't lay it all in that category that this is credit card. Mr. McDonnell, you alluded to more than the idea of just the casual attitude, the loss of any stigma attached to bankruptcy filing these days. As much as anything, I think, a way to manage your credit; go file bankruptcy. You see advertising everywhere. Many of my friends back home advertise for bankruptcy. Just come in and we'll fix you up. So, again, not defending credit cards alone, but there are many reasons for this and I think what we've got to look at are suggestions like Judge Donald is suggesting in her statement, which I've just read, and these bills that are before this House and try to find a fair balance, as, again, Mr. McDonnell has alluded to. Thank you, Mr. Chairman.

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Mr. **GEKAS.** We thank the gentleman. This is now an appropriate time to recess for the purpose of allowing the members to go to the floor to cast votes on two measures, and, at the same time, to allow the second panel and the third panel to grab a bite before returning to the chamber here. We will recess until 12:30.

[Recess.]

Mr. **GEKAS.** The hour of 12:30 having arrived, the subcommittee will come to order. We appear to be in the same posture as we were when we initiated the hearing early this morning, and so we must recess until the appearance of a second member. In the meantime, if you want, I can recite my Shakespearean Sonnets that I have, but in lieu of that I think we'll simply recess.

[Recess.]

Mr. **GEKAS.** The subcommittee will come to order. We note the presence of the gentleman from New York, and therefore a quorum is constituted. We will begin with our second panel. We appreciate the fact that you waited the extra hour and we will proceed expeditiously.

The first individual to be introduced is Thomas H. Boone, Managing Director for Loan Administration of the Countrywide Credit Industries, Inc. of Calabasus, California. Mr. Boone joined Countrywide in 1984 as Managing Director of Loan Administration. He is responsible the largest mortgage servicing portfolio in the industry valued at more than $140 billion.

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Mr. Boone is also Chairman of the Board at Countrywide Agency, Inc., one of the Nation's largest independent insurance agencies. Mr. Boone is a member of the Mortgage Bankers Association and the California Mortgage Bankers Association. Before joining Countrywide, Mr. Boone served as Second Vice President of Real Estate Finance with Chase Manhattan Bank in Los Angeles. Mr. Boone received his Bachelor of Science degree in Accounting and Financing from Lehigh University.

Jeffrey A. Tassey joins him, Senior Vice President of Government and Legal Affairs of the American Financial Services Association in Washington. Before joining the Association, Mr. Tassey served as Counsel to the House Committee on Government Operations and the subcommittee on Commerce, Consumer and Monetary Affairs, where he conducted public hearings and performed legislative oversight activities pertaining to financial institution regulation.

He also served as Banking Counsel and Legislative Director to the Honorable Doug Boniard, former Member of Congress. Mr. Tassey is a graduate of the College of Worcester, and received his law degree from Washington University School of Law. He was awarded a Public Affairs Fellowship at the Hoover Institute at Stanford University.

Mallory B. Duncan joins us, the Vice President and General Counsel of the National Retail Federation. He is responsible for coordinating the efforts of that Federation on bankruptcy issues. Before joining the National Retail Federation, Mr. Duncan was Corporate Counsel with J.C. Penney Company, Inc., where he advised stores and headquarters on Federal and State legislative regulatory issues. He has also served as an attorney advisor in the Office of Policy Planning at the Federal Trade Commission. Mr. Duncan is a graduate of Pomona College and Yale Law School.

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With them is Michael F. McEneney, a partner in Morrison and Foerster in Washington, D.C., who is speaking on behalf of the Bankruptcy Issues Council. His practice focuses on the financial services industry. For more than 10 years, Mr. McEneney has advised various banks and other financial service providers across the Nation on a broad range of financial service issues. He has been actively involved in bankruptcy issues since 1990. Mr. McEneney has written and spoken extensively on various aspects of financial institutional law, including bankruptcy.

And the next witness is the Honorable Eugene R. Wedoff, United States Bankruptcy Judge of the Northern District of Illinois in Chicago, appearing on behalf of the American Bankruptcy Institute. He has served as a bankruptcy judge for the Northern District of Illinois since 1987. Prior to becoming a bankruptcy judge, he was a partner at the Chicago law firm of Jenner and Block, where he specialized in litigation.

Judge Wedoff is a frequent lecturer and has presented papers on a variety of consumer and business issues. He authored the chapter on professional employment in "Chapter 11: Theory and Practice." He currently serves as an associate editor of the American Bankruptcy Law Journal. Today, Judge Wedoff appears on behalf of the American Bankruptcy Institute where he serves as Director and Co-Chair of the Institute's Consumer Bankruptcy Committee. In 1995, Judge Wedoff received the Excellence in Education Award from the National Conference of Bankruptcy Judges. He is a graduate of both the College and the Law School of the University of Chicago.

And the final panelist is Professor Jeffrey W. Morris, of the University of Dayton Law School, on behalf of the National Bankruptcy Conference. Mr. Morris has served on the faculty of the University of Dayton School of Law for 17 years. He is also of counsel to the law firm of Porter, Wright, Morris and Arthur. He has authored three books on bankruptcy law, as well as numerous articles on bankruptcy and commercial law topics. Professor Morris appears today on behalf of that National Bankruptcy Conference where he currently serves as Secretary. In 1997 he was inducted as a Fellow of the American College of Bankruptcy.

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We will begin with the assertion that the written statements will become a part of the record automatically without objection and that the review of that written statement should be confined, if at all possible, to 5 minutes. We will begin with Mr. Boone.

STATEMENT OF THOMAS H. BOONE, MANAGING DIRECTOR OF PORTFOLIO SERVICES, COUNTRYWIDE HOME LOANS, INC.

Mr. **BOONE.** Thank you, Chairman. Thank you very much for allowing me to speak this morning. My name is Tom Boone. I am Managing Director of Portfolio Services of Countrywide Home Loans, which is headquartered in Calabasas, California. It is my pleasure to come before you on H.R. 3150, the Bankruptcy Reform Act of 1998.

For those of you who are not familiar with Countrywide, it is the largest independent mortgage lender in the country. We originated over $6 billion in mortgage loans in the month of February and over $50 billion during the last 12

months. We also service 1.7 billion—excuse me, 1.7 million mortgage loans, about $180 billion worth of mortgage loans.

Bankruptcy has become a very large problem and a growing problem for Countrywide and the other mortgage lenders that I am here to represent today. We are very supportive of the efforts of you and your colleagues in taking this legislation and introducing it as a positive step toward major reform in bankruptcy abuses.

Countrywide has watched over the past several years its customers and bankruptcies grow from about 5,000 in February 1996 to 16,000 as of the end of this past February, over a 200 percent increase. But what we find most alarming about this is during the same period of time in California where we are based, as well as throughout the United States, we have seen a very strong economy. And so this was in light of that strong economy that we saw a 200 percent increase in bankruptcies.

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Let me make it very clear that as a company we support the benefits of bankruptcy for those who are unable to pay their debts and need a fresh start. Countrywide works very closely with thousands of borrowers every month to help them on payment plans to meet their obligations to Countrywide when they find themselves in difficult circumstances, and we also work very aggressively with the courts and chapter 13 are very happy when our mortgagors make it through the chapter 13 bankruptcy and are then able to have a fresh start.

During the past 12 months, the administrative costs of the rising bankruptcies at Countrywide have cost us about $3 million. It is also notable that of our bankruptcies today, only 50 percent of our bankrupt customers are not current on their mortgage payments. In other words, they are current on their mortgage payments and are using the bankruptcy proceedings for other purposes. Eighty percent of our chapter 7 bankruptcies are current on their mortgage payment.

But most important to us is the continued abuse that we are seeing in the practices around the bankruptcy filing. We have seen a continued growth in third parties who claim benefits to the property. And just to give you some examples, what we have seen is, there is one case that we are looking at today that we have provided as Appendix A, where the mortgagor in the course of a year filed 20 bankruptcies to have the stay, and yet each time go in for relief from that stay.

In another case that we are working on today, we have a third party who has gone to 10 of our mortgagors and encouraged them to make their payments to them and grant deed the property to entities that they own or have partial interest in, allowing the mortgagor to continue to make payments to this third party while the third party filed bankruptcy. And we were stayed from pursuing foreclosure on those properties.

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We are continuing to see these scams increase and the number of multiple filings on the part of mortgagors, as well as on the part of third parties as they have transferred partial interest of their properties to those third parties, increase dramatically.

Finally, Mr. Chairman, I would like to mention that we are concerned with the cram-downs and the impact they have on residential mortgage loans. But we are pleased that the chairman shares these concerns and has addressed them in section 130 of your bill.

Mr. Chairman, this concludes my oral presentation on behalf of Countrywide. I would like to thank you for this opportunity to come before you and will be happy to answer any questions you or your colleagues have.

[The prepared statement of Mr. Boone follows:]

PREPARED STATEMENT OF THOMAS H. BOONE, MANAGING DIRECTOR OF PORTFOLIO SERVICES,

COUNTRYWIDE HOME LOANS, INC.

Good Morning Chairman Gekas, Congressman Nadler, and distinguished Members of the committee. I am Tom Boone, Managing Director of Portfolio Services for Countrywide Home Loans, which is headquartered in Calabasas, California. It is my pleasure to come before you to discuss H.R. 3150, The Bankruptcy Reform Act of 1998.

For those of you who are not familiar with Countrywide, we are the largest independent mortgage lender in the country. We originate approximately $50 billion in loans and service 1.74 million, equal to $182.7 billion in loans. Of the 1.74 million loans, 19,977 are in foreclosure and 16,462 are in bankruptcy. Therefore, the bankruptcy issue is of great concern to Countrywide and we are very supportive of the efforts you and your colleagues have taken and view the legislation introduced as positive steps toward major reform in bankruptcy abuses.

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THE BANKRUPTCY CRISIS

We believe it is critical to reverse the increase in consumer bankruptcy filings, which has exceeded 1.3 million in 1997, an all time high.

The rise of bankruptcies is of particular concern because it is happening during a time of economic growth. In the past, the bankruptcy rate reflected a general decline in the economy, or problems in a particular region or economic sector. For example, filings grew in the 1980's because of a collapse of several real estate markets, including my state of California; also high unemployment in some regions, the decline in manufacturing, and instability in interest rates were all factors. By contrast, there is no identifiable economic cause of the current acceleration of filings.

Countrywide supports the societal benefit of providing relief for those who truly are unable to pay their debts because of justifiable, unforeseen circumstances. At the same time, it must be recognized that the effect of bankruptcy on home mortgage lenders ultimately affects the cost of residential mortgage loans, credit availability, or both. In making pricing and underwriting decisions, mortgage lenders consider the frequency of bankruptcy filings, the delays caused by filings, the amount of debt recovered in a bankruptcy, and the legal fees and other transaction costs involved. Delays are of a particular concern to mortgage lenders because they can lead to the deterioration of the residential property securing the mortgage loan, which is maintained by the debtor with little or no stake in the property. Often, by the time the automatic stay is lifted by the bankruptcy court and the lender is permitted to foreclose and sell the residence, the proceeds of the sale are insufficient to pay the mortgage loan in full.

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Lenders who want to remain in business spread their mortgage loan losses to other borrowers in the form of higher interest rates. Any changes in the bankruptcy system that decrease the number of personal bankruptcies will ultimately reduce the cost of home mortgages to consumers and will benefit creditworthy home buyers who are seeking home mortgage financing.

ABUSIVE FILINGS

There are a number of bankruptcy abuses that prevent mortgage lenders from foreclosing on a residence, even when it is certain the debtor is unable to pay the mortgage debt. Attached to this testimony are cases (Appendix A) which illustrate the reason mortgage lenders are concerned with abusive filings. In one situation, there are *twenty* cases purporting to affect our property. Those twenty cases are on *one* mortgage loan. This caused the foreclosure process to be delayed by more than a year. There are several similar examples. The debtor causes the delay by using the simple technique of repeatedly conveying a partial interest in the mortgaged property to a third party, who then filed for bankruptcy relief under Chapter 7. The filing by the third party triggered an automatic stay, delaying foreclosure on the property by two to three months. When the judge dismissed the Chapter 7 filed by the third party, the debtor simply found another transferee to whom a partial interest was conveyed and who filed under Chapter 7 following the

conveyance, again triggering the application of the automatic stay to the mortgage property. This practice of transferring partial interests in the mortgaged property to third parties, who in turn file a bankruptcy petition to delay foreclosure, has become more common in the last several years.

Another example of fraud is rent skimming schemes. In these cases not only are we a victim, but sadly, the borrower is taken advantage of in two ways—first by paying money that never gets to the lender, and second by losing their home through foreclosure. In this example, the debtor (entity) files bankruptcy against several different mortgage loans. The borrower will receive some sort of solicitation stating they can receive assistance with their financial problems. The borrower then begins to pay this entity every month. The person at this entity, unbeknownst to the borrower, will file bankruptcy on the borrowers' mortgage loan and eventually the residence will be foreclosed. In the example we are providing for you, the debtor (entity) has 10 filings on 10 different mortgage loans. Countrywide would be delighted to present additional case histories to the Subcommittee or its staff upon request.

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Your bill, Mr. Chairman, addresses the above-described filing abuses. Section 121 of H.R. 3150 amends section 362 of the Bankruptcy Code to provide that if a case filed by the debtor under Chapters 7, 11 or 13 was dismissed, and if the same debtor files a second case within a year of the dismissal, the automatic stay will terminate within thirty days of the filing of the second case unless the court extends the stay upon a finding that the second case was filed in good faith.

In addition, Section 121 of H.R. 3150 also addresses the situation in which a debtor transfers undivided interest in secured property to third party transferees by permitting the bankruptcy judge to grant *in rem* relief, (*in rem is a technical term used to designate proceedings or actions instituted against the thing*) from the automatic stay. Properly applied, the *in rem* relief would prevent third party transferees who file a petition in bankruptcy from delaying foreclosure on property covered by *in rem* relief because the automatic stay would not apply to the covered property.

Countrywide feels that Section 121 should be strengthened to discourage abusive filings by including the following provisions:

First. To further discourage a debtor from filing numerous petitions, the provision in Section 121 requiring that the automatic stay be lifted in thirty days if a petition is filed by a debtor within one year of the dismissal of prior case should be expanded to provide that the automatic stay will not apply if the debtor files "x" number of cases which are dismissed within a specified period of time. For example, the automatic stay would not apply if a debtor filed a third petition within one year of the dismissal of a case. This approach would discourage a debtor from continuously filing bankruptcy petitions to take advantage of the 30 day stay that is available in Section 121 as currently drafted. At some point, repetitious filings should be treated as being so abusive that the debtor is not entitled to the benefit of the automatic stay.

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Second. To further discourage third party transferees from filing successive petitions in bankruptcy to delay foreclosure on property covered by an order granting *in rem* relief from the automatic stay, Section 121 should be revised to provide that the *in rem* relief applies to all parties with an interest in the property.

The language in Section 121 providing *in rem* relief from the automatic stay currently provides that the *in rem* order will not apply to a third party holding an interest in the property covered by the order unless the third party:

Had reason to know of the *in rem* order at the time the party obtained an interest in the property covered by the order, or

Was notified of the commencement of the proceeding for relief from the stay, and at the time of the notification, no case in which the third party was a debtor was pending.

Requiring that a third party have knowledge of the entry of an *in rem* order or notice of a proceeding for relief from the stay as a condition to imposing *in rem* relief against that party will not significantly curtail the third party transferee abuse described above and documented in Appendix A. For example, a debtor could deed fractional interests in property to three parties without consideration prior to the entry of an *in rem* order or the commencement of a proceeding for relief from the stay. The third parties would not be covered by the *in rem* order because they would not have reason to know of the order at the time their interests were acquired (even if their interests were acquired after the order was entered, they would not have reason to know of the order if the interests were transferred before the order was recorded and they are not "notified" of the motion in which the *in rem* order was granted because the creditor could not have known of their existence at the time the motion was filed). In this example, each of the third party transferees could successively file a petition in bankruptcy and cause the automatic stay to apply to the property covered by the order granting *in rem* relief.

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Innocent third parties with a legitimate interest in the property subject to an *in rem* order can be protected. The court is not required to enter an *in rem* order under Section 121. It is in the judge's discretion. If a third party has a legitimate interest in the property and that is properly recorded—or the judge is advised of that interest by the debtor—the judge can elect not to enter the order or can identify the innocent parties who would not be subject to the terms of the order.

In a number of jurisdictions, bankruptcy judges currently grant unrestricted *in rem* relief when faced with abusive third party filings. The *in rem* language in Section 121 as currently drafted would restrict the scope of those orders and could impede the ability of lenders, trustees and title companies to go to sale on property covered by an *in rem* order entered under Section 121 as currently drafted.

Language suggesting changes to Section 121 reflecting Countrywide's comments is set out in Appendix B.

CONCLUSION

Mr. Chairman, Countrywide would like to thank you and appreciates the opportunity to come before you and share our views and concerns regarding these bankruptcy issues. These issues have a critical effect on the residential mortgage industry and more important, the homeowner. We look forward to working with you and the other Members of this committee and the staff to developing legislation that will bring positive reform in bankruptcy abuses.

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Table 3

Table 4

Table 5

APPENDIX A—CONTINUED
HOLLY R. WOOD

1. File #6574290

April 16, 1997 Irma Annette Jacko transferred 20% interest to Holly R. Wood via Grant Deed

April 16, 1997 Irma Annette Jacko transferred 80% interest to Aruba Group via Grant Deed

Additional bankruptcies—

1) Larry Jacko filed a Ch-13 on March 20, 1997, case #97–15153 / dismissed April 8, 1997

2) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief July 7, 1997

2. File #8290300

December 10, 1996 Donald L. Ballard & Peggy A. Ballard (borrowers) transferred 60% interest to Omega Group & 40% interest to Thomas A. Van Sickle via Grant Deed

January 9, 1997 Thomas A. Van Sickle transferred 60% interest to Omega Group & 40% interest to Edmund J. Maiejewski via Grant Deed

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April 9, 1997 Edmund Maijewski transferred 20% interest to Holly R. Wood & 60% interest to Omega Group via Grant Deed

Additional bankruptcies—

1) Thomas Arthur Vansickle filed a Ch-11 on October 15, 1996, case #LA96–43764VZ / dismissed December 18, 1996

2) Edmund J. Maiejewski filed a Ch-11 on January 6, 1997, case #SV97–10123AG / dismissed March 21, 1997

3) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief June 6, 1997

3. File #6732697

April 8, 1997 Marguerite Mae Jackson transferred 20% interest to Holly R. Wood & 80% to Aruba Group via Grant Deed

Additional bankruptcies—

1) Holly R. Wood filed a Ch-11 on April 9, 1997, case #SA97–15096JB / Obtained relief June 10, 1997

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4. File #7611779

January 16, 1997 Denise A. Swenson (borrower) transferred 40% interest to Edmund J. Maiejewski & 60% interest to Omega Group via Grant Deed

April 10, 1997 Edmund J. Maiejewski transferred 20% interest to Holly R. Wood

Additional bankruptcies)

1) Edmund J. Maiejewski filed a Ch-13 on January 6, 1997 case #SV97–10123AG / dismissed March 21, 1997

2) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief July 1, 1997

5. File #3939469

March 21, 1997 Luz Elena Gamboa (borrower) transferred 40% interest to Edmund J. Maiejewski & 40% interest to Omega Group via Grant Deed

April 9, 1997 Luz Elena Gamboa (borrower) transferred 20% interest to Holly R. Wood via Grant Deed

Additional bankruptcies—

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1) Edmund J. Maiejewski filed a Ch-11 on January 6, 1997, case #SV97–10123AG / dismissed March 21, 1997

2) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief June 18, 1997

6. File #8475725

March 12, 1997 Rosemarie Montenegro transferred 40% interest to Edmund J. Maiejewski & 60% interest to Omega Group via Grant Deed

May 5, 1997 Edmund J. Maiejewski transferred 20% interest to Holly R. Wood via Grant Deed

Additional bankruptcies—

1) Edmund J. Maiejewski filed a Ch-11 on January 6, 1997, case #SV97–10123AG / dismissed March 21, 1997

2) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief July 25, 1997

3) Rosemarie Montenegro filed a Ch-13 on November 6, 1997, case #RS97–29493MG / Obtained relief December 17, 1997

7. File #1702487

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May 19, 1997 Darrin & Theresa Goodman gave their interest to Holly R. Wood via Grant Deed

Additional bankruptcies—

1) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief July 25, 1997

8. File #2345634

May 16, 1997 Scott M. Morse & Christine R. Morse (borrowers) transferred 20% interest to Holly R. Wood & 80% interest to Aruba Group via Grant Deed

Additional bankruptcies—

1) Scott M. Morse filed a Ch-13 on March 20, 1997, case #SA97–13997JR / dismissed May 8, 997

2) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief June 26, 1997

9. File #6072591

December 2, 1996 Nilsa Guillont transferred her interest to Thomas A. Vansickle, Jr. Via Grant Deed

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January 8, 1997 Thomas Vansickle, Jr. transferred 60% interest to Omega Group & 60% interest to Edmund J. Maiejewski via Grant Deed

April 9, 1997 Edmund J. Maiejewski transferred 20% interest to Holly R. Wood via Grant Deed

Additional bankruptcies—

1) Arthur Thomas Vansickle, Jr. filed a Ch-11 on October 15, 1996, case #LA97–43764VZ / dismissed December 8, 1996

2) Edmund J. Maiejewski filed a Ch-11 on January 6, 1997, case #SV97–10123AG / dismissed March 21, 1997

3) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief June 17, 1997

10. File #1837251

April 8, 1997 Luis O. Mas & Leslie W. Mas (borrowers) transferred 20% interest to Holly R. Wood & 80% to Aruba Group via Grant Deed

Additional bankruptcies—

1) Holly R. Wood filed a Ch-11 on April 8, 1997, case #SA97–15096JB / Obtained relief June 17, 1997

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Mr. **GEKAS.** We thank the gentleman. We turn to Mr. Tassey.

STATEMENT OF JEFFREY A. TASSEY, SENIOR VICE PRESIDENT OF GOVERNMENT AND LEGAL AFFAIRS, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. **TASSEY.** Thank you, Mr. Chairman. Members of the committee, my name is Jeff Tassey. I am presenting this testimony on behalf of the American Financial Services Association, AFSA.

AFSA appreciates this opportunity to express its views. I would like to first address some of the on-going issues concerning needs-based bankruptcy, followed by some brief comments on secured lending issues.

Bankruptcy is an extremely complex problem. Opponents of bankruptcy reform claim that the industry has created the problem by indiscriminately extending too much credit, particularly in the form of credit cards. First of all, if bankruptcy was simply a matter of too much credit, bankruptcy rates would be uniform across the country. In fact, they are not. They show wild variations across the Nation and within individual States.

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For example, as Mr. Bryant pointed out, Shelby County, Tennessee has a bankruptcy rate that is 32 times the national average. Does Shelby County get 32 times the amount of credit that the rest of the country does? No, of course not.

Well, then, if not too much credit, what does cause bankruptcy? The causes are very complex. Some of the main causative correlations include divorce, lack of health insurance, lack of mandatory automobile insurance laws and so on.

Urban areas have the highest bankruptcy rates. They also have the highest divorce rates. Young adults between the ages of 21 and 25 have low rates of bankruptcy filing, as do adults over the age of 41. The age group most likely to file are those in their early 30's, particularly age 32. Low-income individuals and minorities have relatively low rates of overall filing, while filings take off as you approach a total annual household income of between $32,000 to $36,000. Filings remain high as income increases.

There is no way to really screen for most of these types of events and characteristics during the underwriting process. Should we not lend to 32-year-olds? Should we ask applicants if they are happily married?

What about credit cards? Bank credit cards account for approximately between 5 and 6 percent of total consumer debt. If you include other types of credit cards, you might get to 9 percent. Is this 9 percent of consumer debt causing all of the problems, while the other 91 percent maintains a benign budgetary impact?

This is counterintuitive. As all of us know, our big obligations are our housing, car, student loans, et cetera. Do credit cards play any role in bankruptcy? Of course, but they are no way the principal cause, any more than too much food in the supermarket is the cause of overeating.

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In general, the role that credit cards play is that they are the last form of credit available for use before filing for bankruptcy. When a debtor gets into financial trouble for whatever, they will frequently try to stay afloat using their credit cards. Or if a debtor is planning to file a bankruptcy of convenience, they will frequently use their cards to acquire certain goods or make certain payments prior to filing.

What about credit card marketing? The fact that credit cards are heavily marketed like other products has resulted in the implication that this is somehow contributing to increased bankruptcies and is otherwise inappropriate.

Why do you receive more than one credit card solicitation? Why do you continue to receive solicitations? As with any other product, credit card providers feel that their card has the best combination of features and that it is differentiated enough that consumers will want to use that card over others.

Another myth that needs exploding is that credit cards are sent unsolicited to consumers. This has been illegal for 30 years. Consumers must affirmatively request the card. They must sign the preapproved application and send it back, all subject to the Fair Credit and Charge Card Disclosure Act, Fair Credit Reporting Act, and other Truth in Lending Act provisions.

Attachment II of my oral statement is a printout from an Internet site that enables consumers to run their own searches on the thousands of credit cards available. Even a cursory search will indicate that this is a competitive market with a wide range of choices.

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It's always easier when confronted with a societal problem to focus on the instrumentality involved, as opposed to finding a policy solution that confronts the behavior involved. We feel that H.R. 3150 strikes the right balance. If a debtor is indeed insolvent, regardless of income or the reason for insolvency, that debtor has the same choices today—chapter 7 or 13.

Under an administrative cutoff based on income, if a debtor is determined to have a meaningful capacity to repay, then the debtor will file a plan in chapter 13 to repay a modest amount of the indebtedness. H.R. 3150 does not

somehow create income where there is none. In no way does H.R. 3150 reward the overextension of credit. In fact, we feel it would encourage the more responsible use of credit.

In addition to the causative factors that I mentioned a minute ago, there are two more that are worth examining. The first is lawyer advertising. While opponents of reform attack credit card marketing as a major cause of bankruptcy, legal marketing is never mentioned.

Fortunately, the Federal Trade Commission has not remained silent on the issue. Attached to my statement is their Consumer Alert warning of potentially misleading lawyer advertising, as well as some sample ads. You can draw your own conclusions here.

A final factor I would like to discuss involves secured lending. In 1978—I will finish right up, Mr. Chairman, with this paragraph, I'm sorry. The final factor I would like to discuss involves secured lending. In 1978, during the last major overhaul of the Bankruptcy Code, one of the major changes that unbalanced the Code between debtor and creditor and in our view has provided an impetus to the increase in bankruptcies is the extraordinary device known as the "cram-down." This has a particular impact on secured vehicle lenders.

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Thank you very much, Mr. Chairman. And again, we appreciate this opportunity to appear before you today.

[The prepared statement of Mr. Tassey follows:]

PREPARED STATEMENT OF JEFFREY A. TASSEY, SENIOR VICE PRESIDENT OF GOVERNMENT AND LEGAL AFFAIRS, AMERICAN FINANCIAL SERVICES ASSOCIATION

The American Financial Services Association (AFSA) appreciates this opportunity to express our views on H.R. 3150, the "Bankruptcy Reform Act of 1998". AFSA is the trade association for a wide variety of non-traditional, market-funded providers of financial services to consumers and small businesses.

We look forward to working with the Subcommittee to pass H.R. 3150 and to achieve a bankruptcy system that protects responsible borrowers through the provision of an appropriate needs based mechanism ensuring that those who can clearly repay a significant portion of their debts, do so. Before directly addressing some of the secured provisions in the bill, AFSA would like to comment on some of the issues that have continually come up when needs based bankruptcy reform is discussed.

CAUSATION—IS IT AS SIMPLE AS TOO MANY CREDIT CARDS?

Opponents of bankruptcy reform claim that the industry has created the problem by indiscriminately extending too much credit in the form of credit cards and simply wants to "turn the government into a bill collector". Nothing is further from the truth on a both a statistical and qualitative basis. First of all, if bankruptcy was simply a matter of too much credit, bankruptcy rates would be uniform across the country. In fact, they are not—they show wild variations across the nation and within the individual states. For example, Shelby County, Tennessee has a bankruptcy rate that is 32 times the national average—does Shelby County get 32 times the amount of credit that the rest of the country does? No, of course not. Well, then, if not too much credit, what does cause bankruptcy? The causes are very complex and frequently a number of factors are present. Some of the main causative correlations include divorce, lack of health insurance, lack of mandatory automobile insurance laws (7 states) and so on. Unemployment in and of itself is not a big factor. Urban areas have the highest bankruptcy rates—they also have the highest divorce rates. Young adults between the ages of 21 and 25 have low rates of bankruptcy filing as do adults over the age of 41. The age group most likely to file are those in their early 30s, particularly age 32. Poor people and minorities have relatively low rates of overall filing while filings take off as you approach a total annual household income of between $32–36,000 and remain high thereafter. There is no way to really screen for most of these types of events and characteristics during the underwriting process. Should we not lend to 32 year olds? Should we ask applicants if they are happily married? The Subcommittee has heard from Stuart Feldstein of SMR Research and his work addresses many of these issues in depth.

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What about credit cards? Bank credit cards account for approximately between 5 and 6 percent of total consumer debt. If you include other types of credit cards, you might get to 9 percent, depending on how you account for convenience users who pay off their balance every month. Is this 9 percent of consumer debt causing all of the problems while the other 91 percent maintains a benign budgetary impact? This is counterintuitive—as all of us know, our big obligations are our housing, car, student loans etc. Do credit cards play any role in bankruptcy? Of course, but *they are in no way the* principal *cause*. In general, the role that credit cards play is that they are the last form of credit available for use before filing for bankruptcy. When a debtor gets into financial trouble for whatever reason, they will frequently try to float themselves using their credit cards, or if a debtor is planning to file a bankruptcy of convenience, they will frequently use their cards to acquire certain goods or make certain payments prior to filing. We have learned to identify some of this behavior and can sometimes reduce our losses, but particularly in case of planned or non-insolvent bankruptcies, this is virtually impossible.

SECURED CREDIT ISSUES

In 1978, during the last major overhaul of the bankruptcy code, one of the major changes that unbalanced the code between debtor and creditor and, in our view, has provided a substantial impetus to the increase in bankruptcies of convenience is the extraordinary device known as the "cram-down".

This is a statutorily based mechanism, found in Section 506(a) of the Code, which provides that every claim filed which is secured by a lien on property is an "allowed secured claim" to the extent of the creditors interest in such property. To the extent that that creditor's interest is less than the total amount of the claim, the claim is an allowed "*un*secured claim." Under the present Code, a secured claim cannot be an allowed secured claim in an amount greater than the value of the collateral.

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As written in the National *Consumer Law Center's Consumer Bankruptcy Law and Practice*, the cram down power provided to the Bankruptcy Court in favor of the debtor by the 1978 Code represents a significant example of a statutorily-supported wealth transfer between a debtor and creditor:

One of the greatest advances for consumers under the (1978) Bankruptcy Code came in the powers they were given with respect to secured debts. Under the prior Bankruptcy Act, relatively little could be done to protect consumer debtors from the holders of such claims. A straight bankruptcy did not generally affect the status of otherwise valid liens or security interests and, as a practical matter, few Chapter XIII plans could get very far with respect to secured claims unless the holders of those claims agreed to the plan or were not affected by it. Now, in contrast, almost every conceivable type of security interest can be altered in some way through bankruptcy , often to a tremendous degree and with very significant benefits for the debtor.

Consumer Bankruptcy Law and Practice, 4th Ed., p. 203.

The workings of the cram down with both real estate and non-real estate have created a large body of law on this mechanism alone. The most recent significant case on how to value collateral for the purposes of determining how to determine the value of the allowed secured claim was *Associates Commercial Corporation* v. *Rash*, which provided that the value of a creditor's collateral for cram down purposes should be what the debtor would have to pay for comparable property ("the replacement-value" standard).

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Secured credit is usually the only "deep pocket" in a consumer bankruptcy case. Since 1978, debtors' advocates have been moderately successful in "unlocking" the secured creditor's pocket through cram downs, "ride throughs",

nonpayment while a plan is being confirmed, Chapter 13 conversions to Chapter 7 after cramdown or cure, and the like. These various developments erode the fundamental distinction between secured and unsecured credit. There are very definite reasons that a lender chooses to extend secured credit over unsecured credit and one of them is certainty of repayment. H.R. 3150 addresses these issues to varying degrees and AFSA supports these provisions. We do feel that the bills' prohibition on cram downs 180 days prior to filing should be substantially extended for secured vehicle lenders, as they suffer the greatest losses on cramdown in the early years of the vehicles life when depreciation is the greatest. We believe that this is an important fact in pre-bankruptcy planning.

SECURED ISSUES ADDRESSED BY H.R. 3150

Chapter 7 and 13 Cases

Multiple Filings. The Bill regulates abusive multiple filings by restricting availability of the stay on the second filing within one year, backed up by a national filing system keeping track of all debtors who file for bankruptcy relief.

The phrase "household goods" as it now appears in section 522(f) of the Code is defined by using the definition already used in a similar context by the Federal Trade Commission in the Trade Regulations Rule on Credit Practices, 16 CFR 444.1(I).

Chapter 7 Cases

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Chapter 7 cases should quickly resolve themselves into reaffirmation or return of the collateral. Debtors are required to fill out a statement of intention with regard to any secured property, and they must either perform their stated intention or return secured property within a short period of time. The need for lift stay litigation is significantly decreased.

The "ride through" is effectively barred. It is now established law in the Second, Fourth and Tenth Circuits, while three other circuits have ruled against it.

Lift stay litigation should be more rapid. There is a sixty day maximum period for the court's decision to be rendered.

Serial or installment redemptions are barred.

Chapter 13 Cases

Clarifies that the inclusion of incidental property in a mortgage on the debtor's principal residence will not disqualify that mortgage from protection under section 1322(b)(2). It also makes clear that if the debtor resided in the house during the six months previous to filing and still owns it, or if the residence is a mobile home, condominium or cooperative apartment, technically treated as personalty in a number of states, the protection of section 1322(2)(b) applies.

Cram downs of consumer goods are limited to retail value, and not available at all for filings within the first 180 days.

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Failed chapter 13 cases cannot be converted to 7 if a convenience user is involved, and even when converted, the cram down is lost.

Interim interest and principal payments must be maintained so that the cash flow stream will not be interrupted by a

filing.

When the creditor is crammed down, the unsecured portion is more likely to be paid because of the disincentives to dismiss or convert and the five year plan requirement for those with more than 75% of median national income.

The automatic stay will not be violated if a prepetition foreclosure proceeding is postponed during the pendency of a Chapter 13 proceeding so long as any prepetition default remains uncured by actual payment in full according to the plan.

Creditors are given better opportunity to get notice of chapter 13 proceedings, the contents of the plan, the hearing upon confirmation, and the like so that rush plans will not be confirmed without creditor participation. At the same time, long delays during Chapter 13 cases, particularly long delayed confirmation, are limited.

Again, AFSA appreciates the opportunity to express its views. We strongly support the efforts of the Committee to develop a modern legal framework for bankruptcy and urge you to move forward with H.R. 3150.

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RICHARD M. MAYER

ATTORNEY AND COUNSELOR AT LAW

KNOXVILLE, TN

JANUARY 9, 1997

HOW TO HANDLE CREDITORS BEFORE FILING BANKRUPTCY

1. Pay those creditors to whom you have pledged property you wish to keep, i.e., house, car or furniture.

2. Do *not* pay any of your other creditors.

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3. Throw away all mail from your creditors.

4. If they telephone you, tell them the following:

a. Do not contact me anymore. If you are contacted by a collection agency, you need to tell them that in writing and that by law they must cease all correspondence.

b. I will not—and refuse to—pay this debt.

c. I do not care about my credit.

d. I have discussed my financial situation with a bankruptcy lawyer. He has advised me to file bankruptcy when my first creditor sues me.

Remember, your wages *cannot* be garnished until you are sued. A court date will be set, which is usually some 30 to 40 days after you receive a civil warrant or summons to court. A judgment is entered which usually happens the day you are supposed to go to court. The judgment becomes final ten days after the judgment is entered. If you tell a creditor you are considering bankruptcy, they might write your debt off their books as it becomes uneconomical for them to have an attorney pursue a debt that will soon be bankrupted.

If you are sued and/or are harassed after telling the same creditor all of the above, please call 588-5111 to set up an appointment. Remember, we can put you in bankruptcy within one to eight days. That is long before any creditor who might have sued you could legally garnish your wages.

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Mr. **GEKAS.** We thank the gentleman. We turn to Mr. Duncan.

STATEMENT OF MALLORY B. DUNCAN, VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL RETAIL FEDERATION

Mr. **DUNCAN.** Thank you, Mr. Chairman, and the other members of the committee for providing the National Retail Federation with the opportunity to testify on various aspects of bankruptcy legislation.

My name is Mallory Duncan. I have been asked to address two items: a non needs-based issue, reaffirmations, and the outlines of the needs-based approach. I'd like to start the discussion outline which is being distributed to you. It demonstrates in very simple terms the concept behind a needs-based approach. I am offering it because there are a number of misconceptions being voiced as to what a needs-based approach would or would not do. Setting it out this way may help everyone understand it.

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In constructing a test, the first question is to ask who is covered. Now ideally, everyone should take some steps to determine whether they need 100 percent relief and whether they should be in chapter 7 or chapter 13. But as a practical matter, persons with modest incomes are less likely to be able to fund a chapter 13 plan, so we must pick a reasonable threshold.

H.R. 3150 chose 75 percent of the median income, or approximately $38,000 for a family of four. It's a very

reasonable choice, but a different number could be used. The important point is that those with incomes below that amount would not be affected by the test at all.

For those who remain, we move to step two. One calculates the debtor's ability to pay by taking their monthly income and subtracting from it three sets of expenses.

The first of those is reasonable monthly living expenses outside of any debts they owe. There are a number of ways of determining that figure, but it should be a fair, recognized standard that makes allowances for family size and regional variations. H.R. 3150 uses the standards that have been developed by the IRS for individuals making repayment arrangements. It's a good model because it is recognized, it allows for regional variations, and it's already in use, but other numbers could be used.

The second deduction is the average monthly payment for secured debt. These are outstanding house and car loans, for example. Third, you deduct payments for priority unsecured debt such as child support and back taxes.

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It is only after you subtract out all of these expenses and obligations that you are in a position to determine whether an individual can afford to repay a significant portion of their debts. H.R. 3150 uses 20 percent as the threshold of significance; it is fair. But other numbers could also have been used. If individuals cannot repay that amount, and the data from the studies indicates, as you would expect, that most filers cannot, then they are unaffected by the needs-based test.

On the other hand, if they can afford to repay all or a significant portion of what they owe, they could still file bankruptcy and would be directed at chapter 13. There, for example, if they could afford to repay 40 percent of what they would owe, they would do so and the other 60 percent would be discharged. That is the test in a nutshell.

As you can see, there are a lot of possible variations. H.R. 3150 makes reasonable assumptions to get a fair and simple result. However, there are a few other points that need to be considered, and they are on the second page of the outline.

First, the system will not work unless people are honest. Unfortunately, today, that often is not the case. The National Bankruptcy Review Commission heard testimony from counsel for debtors who admitted that many filers simply make up numbers on their schedules in order to get the results they want.

One of the few unanimous consumer recommendations from the Commission was that there be some method established to audit filings. In addition, to simplify the review of petitions, certain basic information supporting the filings also should be supplied, such as pay stubs and tax returns.

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Second, there need to be certain procedures for unusual cases. For example, if a filer claims extraordinary expenses, he should document that claim and make it part of his filing. If no one objects, his repayment calculation would be changed accordingly. But there ought to be the possibility for challenges if judges, trustees or creditors see something seriously amiss.

Finally—and this is the last point—there ought to be a means of disciplining those who bring a challenge without adequate basis. Sanctions against the attorneys and penalties against their clients for making clearly unfounded or blanket challenges or other frivolous filings must be in place and enforced.

Some variation of all these principles are incorporated in H.R. 3150. It's an excellent bill. It is simple, as you can see from the outline. It is efficient, since the majority of filers are not materially affected. And it is fair, not only to those who file, but to consumers such as our customers who ultimately pay the cost of the debts that are currently being

discharged by those with an ability to repay.

As to reaffirmations, Mr. Chairman, if I could have one more moment. I'd like to explain how they are used. A reaffirmation is a promise by a bankruptcy filer to enter into a legally enforceable agreement to repay a debt that would otherwise be discharged. Properly used, reaffirmation provides a tool that can help an individual debtor tailor a chapter 7 filing to more closely match his or her needs.

Filing for bankruptcy creates serious adverse consequences for the debtor. That is one reason we believe individuals need education and informed counseling before they file. But once the decision has been made, they need to consider their lives post-bankruptcy.

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In typical reaffirmations, the individual consumers determine, in consultation with their attorney, whether there are one or more lines of credit they can afford and wish to maintain in the future. If so, the debtor's attorney and the creditor agree on the terms and the signed document is included in papers filed with the court.

If the debtor is filing pro se, the bankruptcy judge must review the proposed reaffirmation, advise the consumer as to his or her rights and make a determination as to whether to allow the debt to be reaffirmed. In either case, the consumer is advised as to the wisdom of the reaffirmation by his or her attorney and/or by the judge.

In closing, the disadvantage of reaffirmations is that individuals who presumably are in financial difficulty are potentially obligating themselves to make some payments they could otherwise eliminate, although with the risk of losing secured goods.

The advantage to reaffirmations is that someone emerging from bankruptcy typically has no access to credit in any reasonable form for years after filing. Reaffirmation allows them to preserve a credit link that may be essential for them to have in order to function post-bankruptcy. The decisions are and should be made on a case-by-case basis. Done properly, reaffirmations can be a win-win option for both debtor and creditor.

I want to thank you for the opportunity to present this testimony today. I'd be happy to answer any questions.

[The prepared statement of Mr. Duncan follows:]

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PREPARED STATEMENT OF MALLORY B. DUNCAN, VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL RETAIL FEDERATION

Good Morning. My name is Mallory Duncan. I am Vice President, General Counsel of the National Retail Federation. Thank you Mr. Chairman, and the other members of the Committee, for providing the NRF with the opportunity to testify on the various aspects of the pending bankruptcy legislation.

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.

You are aware that bankruptcies are rising a phenomenal rate. Nationally, in the past two years, filings have risen nearly sixty percent (60%). Chapter 7 bankruptcies are rising even faster.

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. Mr. Chairman, I would like to put these numbers in perspective. It is estimated that $40 billion was written off in bankruptcy losses last year. This money did not just disappear. The cost of these losses and unpaid debts are borne by everyone else. 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 household an average of $400. This year's "bankruptcy tax" threatens to be even higher.

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The trend is not good. 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.

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 what he or she can afford and the court discharges the rest. Not surprisingly, most people choose to file in Chapter 7.

My concern is that more consumers appear to be choosing Chapter 7 sooner and with less justification. For example, for many years we have tracked the payment history of those of our customers who carry and use our store cards. 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 accounts and intervene as necessary. For example we might limit the amount of credit we make available or suggest consumer credit counseling to help them reorganize and to get them back on their feet.

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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. Indeed, for many retailers it has reached the point that more than 40% of the bankruptcy petitions received are from customers (often long-standing) who are not seriously delinquent. It appears that increasingly, bankruptcy is becoming a first step rather than a last resort.

Now I want to be clear. This is not yet the norm; and we cannot expect to eliminate all bankruptcy losses. Some 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.

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. Commendably, H.R. 3150 makes that important distinction.

We all experience temporary financial reversals in life. Most of us learn that, with a some sacrifice and some effort, we can make it through the rough patches in life. But many people no longer see it that way. The rising bankruptcy filings reflect this. Moreover, several recent studies have revealed that there are a significant number of people who are filing for complete relief under Chapter 7 that could actually afford to pay back a notable portion of their debt.

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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. Now you undoubtedly will hear from a few lawyers who conscientiously advise their clients on alternatives to bankruptcy. They will tell you that their clients need relief. By and large they are correct. After all, the average filer does need relief and will not be affected by H.R. 3150.

But those are not the many lawyers who are running the very aggressive ads. They hold out the promise of eliminating debts but fail to talk about the consequences of filing for bankruptcy. Some don't even mention bankruptcy at all—they talk about "restructuring" your finances. These "bankruptcy mills" do us all a disservice. They are encouraging others to exploit the system for purposes for which it was never devised. We cannot allow this to become the norm.

Part of the problem is a lack of consumer financial education. Young people need to learn how to structure a budget; how to manage money wisely, and they certainly need to know about alternatives to bankruptcy.

I also believe that part of the problem is the unfortunate decline in the 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. And their friends and neighbors, not seeing the details of their lives that bankruptcy disrupts, assume that bankruptcy is not such a bad situation. Indeed, one recent study found a five hundred percent increase in less than two years in the number of filers who say they first heard about the idea of filing from a friend or relative. This suggests that for increasing numbers of people, filing for bankruptcy has become the stuff of casual conversations.

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In addition, there have been many high profile celebrity bankruptcies. I cannot help but believe that their continued celebrity, despite having taken what was once considered a shameful action sends a message to the public. For many people, and for many reasons, the stigma of bankruptcy is fast disappearing.

These changes have revealed a flaw in our bankruptcy system. 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 at all, or filing in the wrong Chapter, Congress needs to establish a mechanism that will. Individuals should be given the amount of bankruptcy relief they need. If our bankruptcy system is to continue to be treated with the seriousness and respect it deserves, we must ensure that the public continues to believe its courts dispense fairness and not injustice; that those who receive its relief genuinely need it and are not unfairly shifting their obligations onto others.

In that regard, Mr. Chairman, H.R. 3150 is a very well crafted approach to the growing problem. It recognizes that recovery from bankruptcy requires sacrifice, discipline and compassion. A major virtue is the simplicity of the mechanism by which it helps direct filers to the proper Chapter. Unlike other approaches it neither encourages unnecessary litigation nor does it leave the Chapter 7 court house door wide open for anyone to file regardless of need.

We need a simple, fair and efficient mechanism for delivering bankruptcy relief on the basis of need. That is why an up-front, needs-based approach, such as that contained in H.R. 3150 works so well. That bill establishes 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 plus a few 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. In most cases, the determination would be made "up-front," before the individual goes into court.

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I have been asked to address a non-needs based issue that may be of interest to the Committee: reaffirmations. The pending legislation does not address reaffirmations. Because this issue has been in the news of late, and because it is an important aspect of the bankruptcy code, we want to explain how they are used. A reaffirmation is a promise by a bankruptcy filer to enter into a legally enforceable agreement to repay a debt that would otherwise be discharged by the bankruptcy. A reaffirmation can be for a secured or for an unsecured debt. Properly used, a reaffirmation provides a tool which can help an individual debtor to tailor a Chapter 7 filing to more closely match his or her needs. It also can preserve that debtor's relationship with one or more creditors. Taking away all access to credit from a consumer can, in today's society, itself impose a severe hardship.

Filing for bankruptcy can create very serious adverse economic consequences. That is one reason we believe that individuals need education and informed counseling, *before* they file. But once the decision has been made, they need to consider their lives post-bankruptcy. In typical reaffirmations, individual consumers determine, in consultation with their attorney, whether there are one or more particular lines of credit they can afford and wish to maintain for the future. If so, the debtor's attorney and the creditor agree on the terms, and the signed document is included in the papers filed with the court. If the debtor is filing *pro se*, the bankruptcy judge must affirmatively review the proposed reaffirmation, advise the consumer as to his or her rights, and make a determination as to whether to allow the debt to be reaffirmed. In either case the consumer is advised as to the wisdom of the reaffirmation by his or her attorney and/or by the judge.

The disadvantage of reaffirmations is that individuals who presumably are in financial difficulty are potentially obligating themselves to make some payments they could otherwise eliminate, although at the risk of losing secured goods. (A result most people would not want to occur.) The advantage to reaffirmations is that someone emerging from bankruptcy typically has no access to credit in any reasonable form for years after their filing. A reaffirmation allows them to preserve a credit link that may be essential for them to have in order to function post-bankruptcy. This is especially important when debtors must negotiate a workout on arrears for autos and homes. The decisions are and should be made on a case by case basis. Done properly, reaffirmations can be a win/win option for both debtor and creditor. Done improperly they can unnecessarily burden debtors in need of relief and result in severe penalties against the creditors involved. But without reaffirmations a debtor would have no way to refinance secured loans if later they fell behind in payments or if rates should fall. On balance however, as both many debtors' and creditors' counsel will confirm, they are a decided benefit. They are a useful tool for effectuating the fresh start.

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In closing, on behalf of the National Retail Federation, we want to thank the members of this Committee for moving swiftly to initiate a response to the rising tide of bankruptcies. The retail industry is prepared to work closely with you, Mr. Chairman, and with the other members of the Committee, to further consumer education and to ensure that the integrity of the bankruptcy system is preserved for those who need it and that it is not misused by those who do not. Thank you for your leadership on this important issue.

Mr. **GEKAS.** We thank the gentleman. We turn to Mr. McEneney.

STATEMENT OF MICHAEL F. MCENENEY, PARTNER, MORRISON & FOERSTER, REPRESENTING THE BANKRUPTCY ISSUES COUNCIL

Mr. **MCENENEY.** Mr. Chairman, members of the subcommittee, my name is Mike McEneney. I am partner with the law firm of Morrison and Foerster here in Washington, D.C., and I am here today on behalf of the Bankruptcy Issues Council, which represents more than 6,000 card-issuing members of VISA and MasterCard.

We strongly support H.R. 3150 and urge its approval by this subcommittee. Not only would H.R. 3150 implement needs-based bankruptcy fairly and efficiently, it would also address a number of other problems in the Bankruptcy Code that currently harm American consumers who pay for bankruptcy but don't use it.

At the outset, I would like to address some of the misunderstandings about H.R. 3150 that were highlighted in hearings before the subcommittee last week. I will focus on three areas of confusion.

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First, it has been said that H.R. 3150's needs-based bankruptcy approach would result in more litigation than would approaches that rely on section 707(b). Such a claim is utterly illogical and appears to be based on a misunderstanding about how H.R. 3150 would actually work.

Based on clear, objective standards, H.R. 3150 places the debtor in the appropriate chapter at the start of the process with the need to litigate. The vast majority of cases would then move routinely and efficiently through the system. Under H.R. 3150 any litigation would be limited to the exceptional case that involves a dispute.

By contrast, a section 707(b) approach would require litigation to implement needs-based bankruptcy. Put another way, increased litigation would be a necessity to achieve needs-based bankruptcy in a section 707(b) approach.

Some 707(b) approaches exacerbate this problem by relying on subjective, rather than clear objective standards measuring ability to pay. Thus, the truth is that H.R. 3150's approach by definition will result in less litigation than an approach that relies on litigation alone to achieve needs-based bankruptcy.

Second, there has been some confusion about the expense standards that would be used in H.R. 3150's needs-based calculation. For instance, it has been said that the expense standards do not account for regional variations in the cost of living. That is false. Most of the key variables in the expense standards are determined on the local level.

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For example, the standards for housing costs are determined on a county-by-county basis. The expense standards for utilities are set county by county for every State in the Union. The expense standards for transportation costs are determined on a county-by-county basis.

Moreover, under H.R. 3150, other expense categories are not only regionalized, they are personalized. For example, the needs-based bankruptcy test takes into account the debtor's actual mortgage, auto and other secured loan payments.

There also have been a number of other misstatements about the composition of the expense standards. For example, it has been said that the standards did not include many expenses such as child care. These claims also are false. The truth is that the standards are quite comprehensive. In fact, they take into account the debtor's actual expenditures, not only for child care expenses and education, but also for health care expenses, including health insurance and prescription medications and life insurance costs. The only other category of expenses is the national standards category, and that is adjusted based on income level rather than location.

Third, there has been a good deal of misinformation about how H.R. 3150 would handle a debtor who faces unusual circumstances. Under H.R. 3150, a debtor who has extraordinary expenses, such as a seriously ill child, would simply deduct those expenses from his or her income as part of the needs-based calculation.

In the typical case, those expenses would be accepted and no court review would be required. The only time the court would get involved is in the exceptional case where the extraordinary expenses are challenged. In order to protect against frivolous challenges, the bill provides that a party can be required to pay the attorney's fees and costs of the debtor if the challenge was not substantially justified.

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I want to close by reiterating that while the needs-based provisions of H.R. 3150 have received a good deal of

attention, the bill also includes a number of other important amendments to the Bankruptcy Code.

For instance, H.R. 3150 addresses problems that are created by those who abuse bankruptcy, such as by loading up on credit just before filing, or obtaining a loan when the debtor had no ability to repay.

I thank the subcommittee for the opportunity to appear here today and would be happy to answer any questions you may have.

[The prepared statement of Mr. McEneney follows:]

PREPARED STATEMENT OF MICHAEL F. MCENENEY, PARTNER, MORRISON & FOERSTER, REPRESENTING THE BANKRUPTCY ISSUES COUNCIL

Chairman Gekas and members of the Subcommittee, my name is Michael F. McEneney. I am a partner with the law firm of Morrison & Foerster LLP in Washington, D.C., and I am here today on behalf of the Bankruptcy Issues Council.

The Bankruptcy Issues Council strongly supports H.R. 3150 and urges its approval by this Subcommittee. In particular, we believe that H.R. 3150 would fairly and efficiently implement the kind of needs-based bankruptcy system that is necessary to restore the balance between the interests of debtors who need relief from their debts, and the vast majority of American consumers who pay for the system but do not use it. H.R. 3150 would do so by setting forth clear and objective standards for determining a debtor's repayment capacity. Under those standards, a debtor who could repay a portion of his or her debts would automatically enter into a Chapter 13 repayment plan. A debtor who could not repay would be free to receive a discharge of debts in Chapter 7.

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Furthermore, H.R. 3150 would place debtors in the appropriate chapter—Chapter 7 or Chapter 13—at the beginning of the case. This would heighten efficiency because the vast majority of cases would then move routinely through the system. Under H.R. 3150, disputes would be limited to the exceptional case.

By contrast, a needs-based bankruptcy approach that relies solely on section 707(b), such as that contained in H.R. 3146, would allow debtors to file in either Chapter 7 or Chapter 13, and then require any disputes about debtor repayment capacity to be litigated in a separate judicial proceeding. Moreover, the section 707(b) needs-based approaches that have been introduced would require a court, as part of such litigation, to make *subjective* determinations about matters such as the "reasonableness" of a debtor's standard of living. Clearly, litigation based on such subjective standards would be difficult and costly to resolve—it would require additional court time, more judicial decisions, and the increased expenditure of legal fees.

Thus, we strongly support the needs-based bankruptcy approach that is contained in H.R. 3150. It is important to note, however, that in addition to establishing a fair and efficient needs-based bankruptcy system, H.R. 3150 includes a number of more narrowly focused amendments that are necessary to address specific inequities and other problems in the Bankruptcy Code.

For instance, to support the needs-based provisions of the bill, section 103 of H.R. 3150 defines the circumstances under which a Chapter 7 bankruptcy may be dismissed for "inappropriate use" of the Bankruptcy Code. Section 707(b) of the Code currently provides that a consumer's petition for bankruptcy relief under Chapter 7 may be dismissed by the court for "substantial abuse." Although existing section 707(b) is well intended, it is largely ineffective because of the limitations placed on it at the time it was adopted. Specifically, a claim of substantial abuse cannot be raised by any creditor or anyone else who has a direct pecuniary interest in the bankruptcy case. Substantial abuse may be raised only by the bankruptcy court or by the U.S. Trustee, but even they may not raise the issue "at the request or suggestion of any party in interest." As a result, the parties who are in the best position to identify possible abuse—namely creditors—are precluded from raising the substantial abuse issue. Moreover, the effectiveness of the "substantial abuse" provision is further impeded by the fact that there is no definition of substantial abuse in the Code and courts

are inconsistent in their interpretation of the term. To address these issues, section 103 would amend the Code to change the standard from "substantial abuse" to "inappropriate use," define the term "inappropriate use," and permit creditors and other parties in interest to file a motion for dismissal of a case on the grounds of "inappropriate use."

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In addition, section 405 of the bill would require all debtor filings which refer to the debts of the debtor and all written communications provided to creditors under the Code to contain the account number of the debt owed, if it is reasonably available. This information, which often is not included currently on documents furnished to creditors in connection with bankruptcy cases, would facilitate greatly the process of matching bankruptcy correspondence to creditor records. Many credit card issuers and other creditors operating on a regional or nationwide basis are flooded with thousands of official notices sent by the bankruptcy courts, other creditors, and debtors regarding pending bankruptcy cases. It can be extremely difficult matching these notices with affected accounts, particularly where the account holder has a common last name, or in instances where an individual's name on the bankruptcy notice may vary from the way it appears in the creditor's files. The efficiencies to be gained from the inclusion of this additional information are substantial and the burden to the debtor would be minimal. Moreover, section 405 would require notices to be sent to an address which the creditor has previously specified.

H.R. 3150 provides that a consumer who files for bankruptcy must provide financial information about income and expenses, including tax returns and other income documentation. In order for the parties to assess accurately the likelihood that a debtor is capable of successfully completing a repayment plan, reliable information on the debtor's finances must be made available. To efficiently address this need, section 407 of the bill would amend the Code to require a debtor who files under either Chapter 7 or Chapter 13 to provide the tax returns filed by the debtor during the three (3) years preceding the bankruptcy filing, current pay stubs and other income information.

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H.R. 3150 also would allow non-attorneys to attend and participate in meetings of creditors. For many card issuers and other creditors, the amount of debt involved in a particular bankruptcy case may be too low to justify hiring an attorney for every phase of the bankruptcy proceedings. In order to provide a means by which a creditor could reduce the cost of participating in a bankruptcy proceeding, section 402 of the bill would amend the Bankruptcy Code to allow creditors to train paralegals and other professionals to represent the creditor without an attorney in the meetings of creditors.

The bill also would require that debtors receive a notice of alternatives to bankruptcy—such as debt counseling services—before filing a petition. More specifically, section 111 of the bill would require all debtors to receive, prior to filing for bankruptcy, a notice containing a brief description of Chapters 7, 11, 12 and 13 of the Bankruptcy Code and a brief description of alternatives to bankruptcy. A significant number of individuals who file appear to be unaware of the help that could be provided by non-profit consumer credit counseling services. This provision would amend the Code to ensure that the debtor is made aware of his or her options *before* filing for bankruptcy. The intent of this provision is to provide a consumer protection disclosure to the debtor similar to the consumer protection disclosures required by law when a person obtains credit from a lender.

Furthermore, section 441 of H.R. 3150 would require an annual report of statistical information from bankruptcy cases filed under Chapters 7, 11 and 13. The lack of reliable nationwide data regarding bankruptcies continues to be a serious impediment to determining how the bankruptcy system is functioning, and where it can be improved. A system which improves the data collection in the bankruptcy area would provide objective information from an impartial source that all interested parties can use in their analyses of the bankruptcy system. This provision requires the Director of the Executive Office for United States Trustees to compile and make public an annual report comprised of detailed statistical information from bankruptcy cases.

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Section 408 provides for the automatic dismissal of a filing if required information is not filed within forty-five (45) days of the bankruptcy filing. This provision addresses the problem of debtors who file for bankruptcy and obtain the automatic stay but do not file the schedules required by the Code. A motion to dismiss the bankruptcy filing is usually required if the schedules are not filed. Thus, the automatic stay sometimes remains in effect for several months even though the debtor has not provided the basic information needed to proceed with the case. This provision would automatically dismiss a debtor's case if the schedules are not filed within forty-five (45) days of the bankruptcy filing.

Section 410 of the bill increases to five (5) years the standard length of a Chapter 13 plan for debtors who meet certain income requirements, and retains the three (3) year length for those with income below the threshold. Under the current Bankruptcy Code, the standard length of a Chapter 13 plan is three (3) years and may be extended up to an additional two (2) years "for cause." The general rule limiting Chapter 13 plans to three (3) years is arbitrary and inappropriately short since the debts the debtor is seeking to discharge often involve repayment periods which are longer than three (3) years. On the other hand, we recognize the need to ensure that consumers are not required to fund Chapter 13 plans indefinitely. Thus, we believe the interests of both creditors and debtors are addressed equitably by the provisions of section 410, which would allow Chapter 13 plans to proceed for a period of time to encompass the repayment periods contemplated under many typical consumer credit arrangements, while also ensuring that consumers are not inappropriately burdened by plans that are too long.

Section 171 of the bill would extend the period between Chapter 7 bankruptcy discharges to ten (10) years. The growing popularity of bankruptcy is beginning to spawn increasing numbers of repetitive filers. In order to discourage such behavior, this provision would amend the Bankruptcy Code to preclude a debtor from receiving Chapter 7 relief more than once every ten (10) years (under the current Code, such relief may be obtained once every six (6) years), and prohibit a discharge of debt under Chapter 13 if the debtor has received such a discharge within the five (5) years prior to the order for relief. This would assist in reducing the burden on overworked bankruptcy courts, and discourage reliance on the system as a means to inappropriately avoid financial responsibility while preserving the benefit of bankruptcy relief for debtors who need it.

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H.R. 3150 also addresses problems that are created by those who abuse bankruptcy, such as by loading up on credit just before filing for bankruptcy. Specifically, section 142 of the bill provides that consumer debts owed to a single creditor that were incurred within ninety (90) days prior to filing for bankruptcy are nondischargeable. The Bankruptcy Code, as amended in 1994, provides that certain debts incurred within sixty (60) days prior to filing for bankruptcy are presumed to be nondischargeable. Specifically, debts incurred for luxury goods or services and cash advances obtained within that time frame are presumed to be nondischargeable. The purpose of the nondischargeability presumption is to protect creditors from the practice employed by some debtors of "loading up" on credit in anticipation of filing for bankruptcy relief. The presumption reflects the belief that it is unfair for a debtor to abuse the bankruptcy system by obtaining additional credit when the debtor is on the verge of bankruptcy, and having that debt subsequently discharged. This provision of the Code is a vital protection against bankruptcy abuse. However, because the presumption applies only to "cash advances" and debts incurred to pay for "luxury goods or services," it is too narrowly drawn. For example, the presumption does not cover credit card purchases or other extensions of credit obtained through credit lines, unless it can be demonstrated that the credit was obtained to purchase luxury items. Section 142 of H.R. 3150 addresses this issue by amending the Code to cover all consumer debts owed to a single creditor that were incurred within the nondischargeability period. In addition, Section 142 also would increase the nondischargeability period from the current sixty (60) days to ninety (90) days in order to more adequately protect against bankruptcy abuse.

Similarly, H.R. 3150 addresses abuses that occur when a debtor obtains a loan at a time when the debtor had no reasonable expectation of repaying it. More specifically, section 145 of H.R. 3150 provides that debts incurred without a reasonable expectation or ability to repay are nondischargeable. Under section 523 of the Bankruptcy Code, debts incurred outside the nondischargeability presumption period (currently sixty (60) days, as discussed above) generally are dischargeable unless it can be demonstrated that the debtor incurred the debt with intent to defraud. As a result of this "intent to defraud" standard, it is possible for a consumer to obtain a discharge for a debt incurred at a time when the consumer had no income or other funding sources and, therefore, had no reasonable expectation or ability to repay

the debt. In fact, at least one court has granted a discharge to a consumer for a debt incurred at a time when the consumer clearly could not repay, because the court found that the consumer had a "subjective intent" to repay the debt from anticipated future gambling earnings. See *Anastas* v. *American Savings Bank*, 94 F.3d 1280 (1996). We believe that it is inappropriate for a debtor to obtain a discharge for a debt that is incurred at a time when, based on an objective review of the debtor's finances, it can be concluded that a debtor did not have a reasonable expectation or ability to repay the debt. Thus, we strongly support section 145 of H.R. 3150, which would amend the Code to provide that debts incurred without a reasonable objective expectation or ability to repay are nondischargeable.

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Additionally, the Bankruptcy Code currently provides that debts incurred fraudulently are nondischargeable under Chapter 7. Section 143 of H.R. 3150 would amend the Code to provide the same nondischargeability protection under Chapter 13. This change is necessary to ensure that any portion of fraudulently incurred debts which is left unpaid under a Chapter 13 plan would not be dischargeable.

Moreover, section 141 of H.R. 3150 provides that debts incurred to pay nondischargeable obligations are themselves nondischargeable. Increasingly, governmental entities are allowing consumers to pay tax liabilities by credit cards and other lines of credit. Under the Code, the tax obligations of the debtor are not dischargeable under Chapter 7. Without similar nondischargeability protection for debts incurred to pay taxes, a consumer would be able to use a credit card or line of credit to pay taxes, and thereby convert a nondischargeable tax liability into a dischargeable debt owed to the card issuer. In 1994, Congress addressed this problem with respect to federal taxes by providing that a debt incurred to pay a nondischargeable federal tax liability is itself nondischargeable. However, the problem still exists with respect to debts incurred to pay for state taxes and other nondischargeable obligations such as child support and guaranteed student loans. Thus, section 141 would amend the Code to clarify that a debt incurred to pay a nondischargeable obligation is itself nondischargeable.

Finally, we note that section 112 of H.R. 3150 attempts to begin the process of improving the financial management education and training that is available to debtors across the country. We believe that providing consumers with more financial management educational opportunities is important, and we support this provision of the bill.

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These are only some of the amendments contained in H.R. 3150 that are necessary to address specific inequities and other problems in the Bankruptcy Code that inappropriately increase bankruptcy costs and harm the consumers who pay for the system but do not use it. There are many other important consumer bankruptcy amendments in H.R. 3150 which, when taken together, constitute a well-balanced approach which would result in significant benefits for consumers and creditors alike.

I thank the Subcommittee for the opportunity to appear today, and I would be happy to answer any questions that you may have.

Mr. **GEKAS.** We thank the gentleman. We acknowledge the attendance of the gentleman from South Carolina, the newest member of our subcommittee, Mr. Graham. And with that, we proceed with Judge Wedoff.

STATEMENT OF HON. EUGENE R. WEDOFF, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF ILLINOIS, REPRESENTING THE AMERICAN BANKRUPTCY INSTITUTE

Mr. **WEDOFF.** Thank you, Mr. Chairman. Members of the subcommittee, my name is Eugene Wedoff. I am a bankruptcy judge serving in Chicago, and I am also the co-chair of the Consumer Bankruptcy Committee of the American Bankruptcy Institute.

ABI is the Nation's largest multidisciplinary organization devoted to education and research on issues of bankruptcy and insolvency. Our 6,000 members are lawyers, judges, accountants, trustees, lenders, academics, and others involved

as participants in the U.S. bankruptcy system.

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ABI is nonprofit and nonpartisan; thus, we take no advocacy positions on pending legislation, although we do regularly appear before Congressional committees to assist in the understanding of bankruptcy law and practice.

To the extent that I take any position before you today, it will be based on my personal experience as a bankruptcy judge, rather than an official ABI position. One of the principal insights that my experience as a judge has given me is that our bankruptcy system is complex. The system is required to address multiple interests, such as the interests of debtors in obtaining a financial fresh start, of secured creditors in obtaining prompt access to their collateral, and of various unsecured creditors in receiving the maximum payment possible on their particular claims.

These interests are all legitimate, but they conflict. The balancing of these interests in the Bankruptcy Code necessarily results in complexly interrelated provisions whose impact is not always apparent. Thus, whenever changes are made to the Code, it is possible for those changes to have effects much different or even contrary to what was intended.

With this complexity in mind, I have prepared section-by-section analyses of two of the bills that the subcommittee is now considering, and I hope to complete soon an analysis of the third bill. These analyses have been published by ABI, are available on its web site, and are part of my written testimony today. In them, I attempt to assess the impact of each of the changes that the legislation proposes to make to the Bankruptcy Code and note a number of consequences that may be unintended.

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In my oral remarks today, I would like to focus on just one of the issues addressed by the pending bills, evaluation of collateral. However, if any of the members of the committee have questions about the related topics of reaffirmation and the automatic stay, I'd be happy to address them or any other questions as well.

In nearly every chapter 13 case and in many chapter 7 cases, the debtor seeks to retain property encumbered by a creditor's lien. In such situations, the Bankruptcy Code requires that the debtor pay to the secured creditor the value of the creditor's "allowed secured claim."

Under section 506(a) of the Code, this secured claim is limited to the portion of the creditor's total claim that is actually supported by the value of the collateral. To the extent the claim is not supported by collateral value, it is considered an unsecured claim. To give a simple example: If an auto lender has an outstanding balance of $10,000 on a particular auto loan, but the car is only worth $7,000, then the Bankruptcy Code treats that creditor as having a secured claim for the $7,000 value of the car and an unsecured claim for $3,000.

In these circumstances, which arise very commonly, there is a need to determine how much the collateral is worth. All three of the bills before the subcommittee address this question. H.R. 2500 and 3150 generally take the position advanced by secured creditors—that collateral should be valued according to what the debtor would have to pay to replace it, that is, a retail standard.

H.R. 3146 generally takes the position advocated by debtors—that the collateral should be valued according to what the creditor could obtain by repossessing and selling it, no more than the wholesale value.

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The difference between retail and wholesale can be large. I picked up this book today at the airport in Washington and found that there were frequently differences between the retail and wholesale prices of automobiles in excess of $10,000. With lower priced cars, the retail price was sometimes nearly double the wholesale price. So it makes a

substantial difference which standard is used.

I believe that the wholesale measure better reflects the policies of the Bankruptcy Code. Payment to a secured creditor in bankruptcy is a substitute for the secured creditor taking the collateral, so it is hard to see why the secured creditor should be paid more through bankruptcy than the creditor would have received by actually taking the collateral.

The Supreme Court also pointed out in its recent Rash Decision, which deals with this issue, that the retail price often reflects items such as reconditioning, inventorying, and warranties that are in no sense part of the value of the collateral retained by the debtor.

The only justification I have seen for using retail price as a measure of value is that it compensates the secured creditor for the delay and risk it faces in bankruptcy in obtaining its collateral. But this delay and risk should be dealt with by the interest that the secured creditors are paid when there is time payment of the claim. Moreover, the proposals before the subcommittee apply a retail standard even if there is no risk, because the creditor is paid in a lump sum, as in redemption in a chapter 7 case.

Now, the clear intent of the retail price approach is to obtain higher returns for secured creditors, but there are very likely unintended consequences. First, in most chapter 13 cases, there is a fixed amount available to pay claims, so, as the payment to secured creditors goes up, the money available to pay unsecured creditors necessarily goes down in a chapter 13 case. Second, it may be, if the secured debt is made artificially high, a debtor will not even be able to complete a chapter 13 case, because most secured claims must be paid in full during the course of a chapter 13 plan.

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Finally, consider the position of a secured creditor who actually receives its collateral during a chapter 7 or chapter 13 case, through repossession. As I read H.R. 2500 and H.R. 3150, such a creditor would have a secured claim based on the retail price of the repossessed collateral, even though the secured creditor would not be able to obtain the retail price in repossessing and selling the property. I think that may be one of the unintended consequences I talked about.

Again, my point here is not so much to advocate the position of any party, as it is to urge a careful consideration of all of the effects of any proposal, and I pledge that ABI will do its part in that process. Thank you.

[The prepared statement of Judge Wedoff follows:]

PREPARED STATEMENT OF HON. EUGENE R. WEDOFF, U.S. BANKRUPTCY JUDGE, NORTHERN DISTRICT OF ILLINOIS, REPRESENTING THE AMERICAN BANKRUPTCY INSTITUTE

Mr. Chairman and members of the Subcommittee, my name is Eugene R. Wedoff. Since 1987, I have been a U.S. Bankruptcy Judge for the Northern District of Illinois, in Chicago. I am a graduate of the University of Chicago and its law school. I am also currently the co-chair, along with the Hon. William H. Brown, of the American Bankruptcy Institute's Consumer Bankruptcy Committee, and I am pleased to present the ABI's views today.

As you know, the ABI is the nation's largest education and research organization of bankruptcy professionals, with over 6,000 members. Our members are attorneys, judges, accountants, lenders, academics, trustees and others involved in the bankruptcy system. We maintain a comprehensive Internet site (ABI World) at www.abiworld.org. ABI is non-profit and non-partisan and thus we take no advocacy position on the current proposals.

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To the extent I give you an opinion today, it is in my personal capacity based on my analysis of the legislation and my experience as a judge, and not an official ABI position. We commend the Subcommittee for the attention devoted to improving the bankruptcy system and stand ready to assist in your understanding of the impact of the various

proposals.

INTRODUCTION: THE GENERAL OPERATION OF CONSUMER BANKRUPTCY.

H.R. 3150, currently pending before the 105th Congress, proposes major changes to the consumer provisions of the Bankruptcy Code (Title 11, U.S.C.). Similar changes have been proposed by two other bills, H.R. 2500 and S. 1301, that are the subject of an earlier analysis published by the American Bankruptcy Institute. Like the earlier analysis, this paper reviews the proposed legislation with three aims: first, identifying each of the changes that the bill would make in current consumer bankruptcy law; second, assessing the impact that these changes would have in the operation of the law; and third, suggesting alternative approaches, as appropriate, to achieving the goals of the bill. Where the provisions of H.R. 3150 are substantially the same as those of H.R. 2500 or S. 1301, the comments from the earlier analysis are reproduced here, to avoid the need for cross-reference.

In order to discuss the proposed changes and their impact, it is necessary first to have an understanding of how consumer bankruptcy operates under the present law. It is helpful to look at the law as a two-part system, that (1) determines the assets that are available to consumer debtors and (2) divides the assets, allowing the debtor to retain some of those assets, and using other assets to pay the various of the debtor's creditors.

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THE ASSETS AVAILABLE. All consumer debtors have the same two basic types of assets available to them: present assets and future assets. The present assets are what a debtor owns at the time a bankruptcy is filed. These include tangible assets like a home, a car, clothing, furniture, and cash, as well as intangible assets, like savings and retirement accounts and lawsuits for personal injury. Future assets are those to which a debtor first becomes entitled after a bankruptcy is filed. The principal future assets of most debtors are the personal earnings to which they become entitled after the bankruptcy filing; other future assets include gifts received or lawsuits accruing after the filing.

THE CLASSES OF CLAIMS. In a bankruptcy case, the assets available to the debtor are divided between the debtor and the debtor's creditors. The share of each creditor depends on the type of claim the creditor holds. The Bankruptcy Code sets out several different classes of claims.

(a) Secured claims. Debts that are supported by liens on property owned by the debtor (like a home mortgage, or a lien on an automobile), are known as "secured claims." The Bankruptcy Code generally provides that secured claims must be paid at least the value of the collateral that supports them before that collateral can be used by the debtor or paid to other creditors. In other words, the debtor and other creditors are only entitled to the "equity" that exists in the property above the amount of the claim for which the property is collateral. In this way, secured claims are generally first in the distribution of a debtor's assets. Claims that are not supported by a lien on property of the debtor are known as "unsecured" claims.

(b) Priority claims. Certain claims are viewed by the Bankruptcy Code as being especially entitled to payment. Examples include certain tax obligations, expenses of administering a case in bankruptcy, and family support obligations of the debtor. Although these claims against the debtor may not be secured, the Bankruptcy Code provides that when a debtor's assets are distributed, these claims should be paid ahead of other unsecured claims, and so they are known as "priority unsecured" or simply "priority" claims, in contrast to ordinary ("general") unsecured claims against the debtor.

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(c) General unsecured claims. Unsecured claims that do not have priority status—"general unsecured" claims—are involved in nearly every consumer bankruptcy case. Examples include most credit card debt and medical bills. However, even a creditor secured by a home mortgage or automobile lien may hold a general unsecured claim. An important concept in the Bankruptcy Code is that, whenever the value of collateral is insufficient to cover the entire amount owed on the creditor's claim, the creditor holding the lien has both a secured claim (to the extent of the

collateral value) and an unsecured claim (in the amount of the deficiency in the value of the collateral). Thus, a creditor with a $10,000 claim, secured by an automobile worth only $7,000, is treated as having a secured claim of $7,000 and a general unsecured claim of $3,000.

(d) Nondischargeable claims. Ordinarily, when the distribution of a debtor's assets under the Bankruptcy Code has been concluded, the debtor is given a discharge, wiping out the debts that the debtor owed at the time the bankruptcy was filed. Thus, all of the debtor's future assets, after the distribution, are allowed to be retained by the debtor. However, there is an exception to the discharge for certain types of debt. Some of this debt is of the same nature as priority debt (taxes and family support obligations), but the Bankruptcy Code also excepts from discharge certain debts that were incurred through misconduct of the debtor, such as debts arising from fraud and intentional injuries. These "nondischargeable" claims—to the extent they have not been paid from the assets that are distributed during a bankruptcy case—remain payable from the future assets of the debtor.

CHAPTER 7**: DISTRIBUTING PRESENT ASSETS TO CREDITORS.** Since the enactment of the Bankruptcy Act of 1898, the standard process of a bankruptcy case has been for a trustee to collect the debtors' present assets, liquidate them, and divide the proceeds among the debtors' creditors, with the debtors, in exchange, being discharged from their debts, so that they retain the right to their future assets, free of claims of creditors. This process, set out in Chapter 7 of the current Bankruptcy Code, is known as "liquidation" or "straight bankruptcy." Allowing the debtors to use future assets free of creditor claims is known as the "fresh start."

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There are, however, two features of Chapter 7 that vary the general plan of liquidating present assets for distribution to creditors and leaving future assets for the debtor. *First*, debtors are allowed to retain some of their present assets. The Bankruptcy Code sets forth a list of "exempt" property, deemed necessary for debtors' maintenance. States may provide an alternative to this list, and then either allow the debtors to choose between the two lists of exempt property (state and federal) or else provide that the state exemptions are the only ones available. In any event, debtors are allowed to keep some of their current assets as exempt, excluding them from distribution in Chapter 7. Where debtors have no substantial assets beyond those that are exempt, there will be no distribution to creditors. Cases such as these are known as "no asset" Chapter 7 cases.

Second, debtors in Chapter 7 are not always discharged from all of their debts. As noted above, some debts are nondischargeable, and these remain, after bankruptcy, so that the creditors holding these claims may seek payment from future assets of the debtor. Moreover, under certain circumstances (generally involving misconduct by the debtor in the course of the bankruptcy itself), a Chapter 7 debtor may be denied a discharge altogether.

Taking all of this into consideration, Chapter 7 generally divides a debtor's assets as follows:

(1) Secured creditors are given the value of their liens in the debtor's present assets.

(2) The debtor's exemptions are deducted from the present assets.

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(3) Any remaining present assets are liquidated and distributed, first to priority claims, and then to general unsecured claims.

(4) The debtor is given a discharge, allowing the debtor to have future assets free of creditor claims, subject to nondischargeable claims.

(5) Nondischargeable claims remain payable in full from the future assets.

CHAPTER 13**: DISTRIBUTING FUTURE ASSETS TO CREDITORS.** Chapter 13 is presented in the

Bankruptcy Code as an alternative to the standard Chapter 7 liquidation. The basic idea of Chapter 13 is to allow debtors to retain all of their present assets, in exchange for paying to creditors, out of future assets, at least as much as the creditors would have received if there had been a Chapter 7 liquidation. To accomplish this, the debtor must propose a plan, administered by a trustee, to pay creditors through periodic contributions from the debtor's regular income. Chapter 13 recognizes that debtors cannot pay all of their income into the plan, since some income will be necessary for the support of the debtors and their dependents. However, all income not necessary for that support is defined as "disposable" income, and a Chapter 13 plan must either pay creditors in full, or devote all disposable income to the plan. A plan that does not provide for full payment of debts must have a duration of at least three years, and five years is the maximum length of the plan. Because of the disposable income requirement, it is possible for Chapter 13 plans to pay much more to creditors than they would have received in a Chapter 7 bankruptcy.

Under current law, Chapter 13 is entirely voluntary. Only a debtor can propose a Chapter 13 plan; a debtor has an absolute right to dismiss a case that was originally filed under Chapter 13; and a debtor can convert a Chapter 13 case to Chapter 7 at any time. To encourage debtors to choose Chapter 13 over Chapter 7 (and thus provide greater payment to creditors), the Bankruptcy Code has two distinct types of incentives. First, at the conclusion of a Chapter 13 plan, the debtor is given a broader discharge than is available in Chapter 7. This "superdischarge" results in the discharge of several types of debt (including those for fraud and intentional injuries) that are not discharged in Chapter 7. Second, debtors are allowed to keep property that is encumbered by liens, even though they are in default on the underlying obligations. A debtor with a home in foreclosure or a car subject to repossession may be able to retain the home or car by making payments to the secured creditors through a Chapter 13 plan. Moreover, except for certain home mortgages, the debtor in Chapter 13 may pay to a secured creditor the value of the collateral, even though it is less than the full amount owing, and obtain a release of the lien. Chapter 13 contains detailed provisions as to the type of payments required on secured claims.

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Plans in Chapter 13 are required to pay priority claims in full, over the course of the plan, and not to discriminate unfairly among general unsecured creditors. Considering all of its provisions, Chapter 13 generally divides a debtor's assets as follows:

(1) The debtor retains all present assets.

(2) The debtor contributes disposable future assets to a plan for a period of three to five years, or for a shorter period sufficient to pay the debts in full. The payments to be received by creditors must be at least as much as they would have received in a Chapter 7 case. Secured creditors must receive at least the value of their liens. Priority claims must be paid in full.

(3) The debtor retains all nondisposable future assets during the time of the plan.

(4) After the completion of the plan, the debtor is given a discharge, allowing the debtor to retain all future assets, free of dischargeable creditor claims.

(5) Nondischargeable claims remain payable in full from the future assets. However, many debts that are nondischargeable in Chapter 7 are able to be discharged in Chapter 13.

CHOICE OF CHAPTER 7 **OR CHAPTER** 13. Under current law, consumers have a largely free choice between Chapter 7 and Chapter 13 as a form of relief. However, there are some limitations, the most significant of which are the following: First, a debtor cannot file any bankruptcy case within 180 days after a prior case was dismissed under specified circumstances. Second, Chapter 13 is unavailable to individuals with large amounts of debt (over $250,000 in unsecured debt or $750,000 in secured debt). Third, a Chapter 7 case may be dismissed on motion of the court or the United States trustee if granting Chapter 7 relief would be a "substantial abuse." Fourth, a debtor cannot receive a discharge in a Chapter 7 case if that case was filed within six years of an earlier filing in which the debtor received a Chapter 7 discharge.

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THE AUTOMATIC STAY. In either Chapter 7 or Chapter 13, an automatic stay goes into effect at the time the case is filed, which generally operates to prohibit any collection activity—including foreclosure and repossession—on debts that were in existence at the time of the filing. In order to obtain the right to proceed with collection activity, a creditor must obtain relief from the automatic stay. In either Chapter 7 or Chapter 13, a creditor is entitled to relief if the value of its lien is declining or at risk of declining, and no action (known as "adequate protection") is taken to make up for the decline. In Chapter 7, the creditor is also entitled to relief if there is no equity in the property that might be obtained for the benefit of creditors. In Chapter 13, relief is granted if there is no equity and the property is not needed for the debtor's plan to be effective.

SUMMARY: MAJOR EFFECTS OF THE CONSUMER BANKRUPTCY PROVISIONS OF H.R. 3150.

As discussed in the section-by-section analysis that follows, H.R. 3150 appears designed to reduce bankruptcy filings and increase payments to creditors in bankruptcy. A number of features that would increase the cost of bankruptcy filing and administration The major changes proposed in H.R. 3150 include the following:

1. After a debtor received a bankruptcy discharge, the debtor would be ineligible for any bankruptcy relief for a period five years, and ineligible for Chapter 7 relief for a period of 10 years, without consideration of good faith or economic situation. 171.

2. Chapter 7 relief would be denied to a class of debtors, based on ability to pay a specified portion of their debt. Debtors with relatively large debt would remain eligible for Chapter 7 relief, those with smaller debt would be ineligible. Testing for eligibility would be required for most debtors. 101, 103.

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3. Chapter 13 would be changed by increasing minimum plan terms and eliminating the superdischarge. 102, 410, 508.

4. Debtors would be notified about alternatives to bankruptcy, and of their obligations in filing bankruptcy. These obligations would include submission of tax returns to the United States trustee (with disclosure to any interested party), and filing of detailed information regarding income, expenses, and assets, subject to formal audit. 111, 404, 407.

5. In both Chapter 7 and Chapter 13 cases, secured creditors would receive payment of their claims in an amount no less than the retail value of the collateral that secures the claim, and, in some circumstances, the full amount of the claim, regardless of collateral value. 128, 129, 130, 162. Relief from stay would be granted in certain circumstances without regard to equity available for distribution to creditors generally. 121, 124.

6. "Fraudulently incurred" credit card debt would be determined without regard to the intent of the debtor to repay, but rather on the debtor's objective financial situation at the time the debt was incurred. Such debts would be nondischargeable in both Chapter 7 and Chapter 13 cases. They would be presumed nondischargeable when incurred within 90 days of the bankruptcy filing. 141, 142, 143, 145.

7. New deadlines would be established for important events in consumer bankruptcy cases, but there are conflicting provisions regarding the time for confirmation of a Chapter 13 plan. 401, 405, 406, 409.

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8. Bankruptcy court decisions would be appealable directly to the circuit courts of appeals. 412.

9. Detailed provisions are set out regarding centralized collection and dissemination of bankruptcy data. 441–43.

H.R. 3150 would make no substantial change in exemption law. 181, 502.

THE CONSUMER BANKRUPTCY PROVISIONS OF H.R. 3150: SPECIFIC PROPOSALS.

More than 40 of the sections of H.R. 3150 affect consumer bankruptcy cases. These provisions are included in three of the bill's titles. Title I ("Consumer Bankruptcy Provisions"), Title IV ("Bankruptcy Administration"), and Title V ("Tax Provisions"). This analysis deals with each of these sections in the order of presentation; cross-references indicate areas in which one proposal affects another. An indication is also given where the substance of the proposal is similar to a provision of H.R. 2500 or of S. 1301.

Title I ("Consumer bankruptcy provisions")

Subtitle A ("Needs-Based Bankruptcy")

101 ("Needs based bankruptcy") (see H.R. 2500, 101; S. 1301, 102).

THE CHANGES. This section of the bill would eliminate the choice of Chapter 7 bankruptcy for certain debtors. Subsection 101(3) of the bill would add a new provision to 109(b) of the Code. This new provision would prohibit an individual from being a debtor under Chapter 7 if the individual had "income available to pay creditors." The remainder of 101 sets up a definition of "income available to pay creditors" and a mechanism for enforcing the denial of Chapter 7 relief to debtors who have such income.

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The definition of income available to pay creditors. Whether a debtor has "income available to pay creditors," and thus is ineligible for Chapter 7 relief, depends on the application of three tests, set out in subsection 101(4). The first test compares the debtor's "current monthly total income" (all of the debtor's income from any sources, averaged over the six months preceding bankruptcy) against the national median income, as established by the Census Bureau. The debtor's income must be at least 75% of the national average in order to meet this test.

The second and third tests are based on the debtor's "projected monthly net income." The projected monthly net income is defined as the debtor's current monthly total income, reduced by three categories of expenses: (1) general living expenses for the debtor and the debtor's dependents, as determined by the Internal Revenue Service for the area in which the debtor lives; (2) all of the payments on secured debt that will come due during the five years after filing, divided by 60 (to obtain a monthly average); and (3) all of the priority debt owed by the debtor, again divided by 60. Finally, there can be a further reduction if the debtor establishes extraordinary circumstances. The debtor will be found to have "income available to pay creditors" if, in addition to meeting the total income test, the debtor's "projected monthly net income" is both greater than $50, and is "sufficient to repay twenty per cent or more of unsecured non-priority claims during a five-year repayment plan."

The enforcement mechanism. Section 101 of the bill contains two mechanisms for enforcing the prohibition against Chapter 7 relief for debtors with "income available to pay creditors." First, Chapter 7 trustees are given the additional duty of investigating and verifying the debtor's projected monthly net income and filing a report with the court as to whether the debtor is disqualified for Chapter 7 relief under the "income available" standard.

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The second enforcement mechanism has to do with extraordinary expenses that might be asserted by the debtor. If the debtor asserts such expenses, a statement to that effect is required to be included with the debtor's bankruptcy petition, together with an itemization and detailed description of each expense, and a sworn statement by the debtor and the debtor's attorney that the statement is true. Any party may object to the statement within 60 days after the debtor makes the disclosures required by 521 of the Code (as expanded by 407 of the bill, discussed below), and if such an objection is made, the bankruptcy court is to determine the matter, with the debtor having the burden of proof.

Impact on Chapter 13. Finally, Subsection 101(6) of the bill sets out a provision unrelated to eliminating Chapter 7 relief for debtors with the defined "income available to pay creditors." This final change would impose on Chapter 13 trustees the additional responsibility of investigating and verifying the debtor's monthly net income, and filing annual reports with the court as to whether the debtor's plan should be modified because of changes in the debtor's net income.

THE IMPACT. Section 101 of the proposed bill would effect a major change in bankruptcy policy. That policy has traditionally allowed debtors in financial difficulty to obtain an immediate fresh start in exchange for surrendering their nonexempt assets. That policy is reflected in current 707(b), which denies Chapter 7 relief only where this would be a "substantial abuse" of the provisions of Chapter 7, and which provides that there is a presumption in favor of granting the relief sought by the debtor. The proposal would change this, denying an immediate fresh start to a significant category of debtors in genuine financial difficulty if they have enough income to pay a specified portion of their debt. Thus, at a given income level, those who have accumulated relatively small amounts of debt can be denied Chapter 7 relief, while those who have accumulated relatively large amounts remain eligible. It can be anticipated that this change would decrease the number of Chapter 7 bankruptcies, with an increase in Chapter 13 cases or in nonbankruptcy resolutions of consumer debts. This may lead to greater payments to creditors. But such a major change in bankruptcy policy may have consequences beyond those that might be anticipated. For example, at the present time, many debtors are able to avoid bankruptcy by working out voluntary arrangements with creditors through credit counseling services. The willingness of creditors to cooperate in such voluntary arrangements may be influenced by the fact that the debtors otherwise have the option of Chapter 7 bankruptcy. If that option is removed, the creditors may be less willing to enter into the voluntary arrangements. The change may also have an impact on home foreclosure rates, since debtors now able to remove other debt in Chapter 7 would be denied that option, and may be ineligible for Chapter 13 or unable to complete a Chapter 13 plan.

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There are also two features of the proposal, respecting median income, that may have effects different from those intended. Median household income, varying with size of the household, is used in the proposal to establish a threshold below which there is no need to examine income on an individualized basis—an individual whose total household income is less than 75% of the median income for a household of the same size would not be disqualified from Chapter 7 relief regardless of the household expenses. The first difficulty with the proposal in this respect is that it requires the use of outdated information. For any given year, the proposal states that household income is based on the most recent Census Bureau figures available as of January 1. As of January 1 of any year, the Census only has information available for the second year before that date. Thus, 1996 income figures are presently the most recent. In this way, the threshold under the proposal compares a debtor's current income to the median income that existed up to two years earlier. In times of high inflation, this would greatly increase the number of cases subject to individual scrutiny. (Similarly, the six-month average used to determine the debtor's current income will result in an artificially high income figure whenever the debtor's income has declined shortly before the bankruptcy filing.)

The second problem has to do with household size. The proposal apparently employs median household income, varying with the size of the household, in order to allow a larger threshold income for larger households. In reality, however, median household income changes erratically with household size. The median income for a single individual (in 1996, the last year for which Census Bureau figures are currently available) was $18,426, so that any single individual earning over $13,819.50 would be subject to individualized scrutiny under the proposal. This is only about $4,500 more than the federal poverty level of $9,260. But median income for a household of two was $39,039, producing a threshold for scrutiny, under the proposed bill, of $29,279.25, more than twice the poverty level of $12,480. The median income continues to increase with household size for households of three and four persons, but household income *decreases* for families of five and six persons. The median family income for a household of six persons was $44,782 in 1996—less than the median income for a family of three—which would result in a threshold for scrutiny, under the proposed bill, of $33,586.50, compared to a poverty level of $25,360. Thus, for single individuals and individuals in large households, the bill is much more likely to require individualized scrutiny than for individuals in households of two to four persons. (Income figures are drawn from U.S. Bureau of the Census, P60–197, *Money Income in the United States: 1996*, Table 1 (1997). Poverty figures are from the Annual Update of the HHS Poverty Guidelines, 63 Fed.Reg. 9235 (1998).)

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Beyond these policy considerations, there are four practical impacts that can be anticipated:

(1) A substantial burden would be placed on the Internal Revenue Service to create standard levels of expense for each distinct economic area in the country, and to keep these standards updated. Such determinations by the IRS will likely require formal rulemaking procedures; the definition of "rule" in the Administrative Procedure Act, 5 U.S. C. 551(5), includes "an agency statement of general . . . applicability and future effect designed to implement . . . law or policy." In any event, the IRS would be required to establish standard expense levels for households of varying size in each discrete economic area of the country. This would be a particular problem with respect to housing expenses. The bill excludes secured debt payment from projected monthly net income, and so mortgage payments are automatically deducted from income available to pay creditors, even if the mortgage payments are much higher than average for the community in which the debtor resides. However, rental payments are not secured debt, and so would only be excluded to the extent that they were part of the standard levels of expense established by the IRS. Rental expenses vary widely from community to community within a metropolitan area. Unless different expense figures for housing were created for each distinct housing area, the impact of the proposal could be to require all debtors in higher than average rental communities to declare and prove "extraordinary" expenses. Moreover, even if the housing expenses established by the IRS were very detailed, there would remain questions concerning the extent to which bankruptcy courts should allow as "extraordinary expenses" rental payments at a level higher than that determined by the IRS.

(2) An increased burden would be placed on bankruptcy professionals. The proposal requires Chapter 7 trustees to investigate and report on the debtor's net income in each Chapter 7 case. The vast majority of Chapter 7 cases involve no assets for distribution to creditors, and hence only a nominal fee for the trustee. The new investigation and report will substantially add to the work required of trustees in no-asset cases, with no provision for additional compensation. (The investigation and reporting requirements for Chapter 13 would increase the costs of the Chapter 13 trustee, reducing the portion of plan contributions available to creditors.) Similarly, the proposal requires debtors' counsel to swear to the accuracy of any extraordinary expenses claimed by a Chapter 7 debtor. Unless this oath is simply based on the statement of the debtor (in which case it would add nothing to the debtor's oath), this requirement would impose on debtors' counsel the obligation of independently verifying all of the extraordinary expenses claimed by the debtor, thus increasing the cost of the bankruptcy and the time required to file the case.

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(3) The proposal would lead to increased "bankruptcy planning by some sophisticated debtors." The formula employed for determining net monthly income is subject to manipulation. Most obviously, because secured debt is excluded from projected monthly net income, a debtor can reduce the income available to pay debts simply by taking on additional secured debt. For example, assume that a debtor with $30,000 in unsecured, nonpriority debt owns a three-year old car with no outstanding car loan, and that the debtor has $300 in monthly net income as defined in the proposed bill. Over five years, that income would total $18,000, well over 20% of the unsecured debt. However, if the debtor trades in the three-year old car for a new one, and finances $12,000 for three years at 5% interest, the debtor will need to make payments on the secured car loan of about $13,000, reducing the total "net income" over the five years after filing to about $5000, less than 20% of the unsecured debt. Similarly, a debtor with projected income that is slightly over 20% of outstanding unsecured debt could increase the amount of that debt to arrive at a point where disposable income is less than 20%. Finally, debtors may be able to manipulate income, by terminating second jobs, reducing hours, or changing employment.

(4) The proposal would lead to greater court involvement in Chapter 7 cases—cases which now rarely go before a judge. The court will be required to hear any disputes regarding extraordinary income, as well as any questions of good faith arising out of the kind of bankruptcy planning discussed above. These hearings will generate additional expense for the courts and the parties involved in them.

ALTERNATIVES. The Bankruptcy Code has limited the availability of Chapter 7 relief in situations of improperly

incurred debt by creating exceptions to discharge in Chapter 7. To obtain relief from the improperly incurred debt, the debtor is then required to complete a Chapter 13 plan. Rather than making Chapter 7 relief unavailable to a large class of debtors (many of whom will have incurred their debt in good faith), it may be preferable to define the type of debt (such as excessive credit card debt) that is improper, and make that debt nondischargeable in Chapter 7, regardless of the disposable income currently available to the debtor. Alternatively, if there are to be thresholds for denial of Chapter 7 relief based on household income, those thresholds should be based on some formula (such as a multiple of poverty level) that is not tied to median household income.

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102 ("Adequate income shall be committed to a plan that pays unsecured creditors") (see H.R. 2500, 102).

THE CHANGES. Section 102 of H.R. 2500 proposes essentially two major changes in the operation of Chapter 13.

Plan length. First, 102 imposes an increased minimum plan length for most debtors. Instead of the current three-year minimum, the proposed legislation provides that, if the debtor's total income is 75% or more of the national medium income, based on household size, the debtor's plan must have a duration of at least five years. If the debtor's total income is less than 75% of the national medium income, the three year minimum is retained. (These provisions are elaborated in 410 of the proposed bill which sets out maximum plan lengths of two years in addition to the minimum plan length set forth here.)

Minimum payments to unsecured creditors. The second major change proposed by 102 replaces the current "disposable income test" of Chapter 13 with a two-part formula requiring minimum payments on unsecured nonpriority debt. Under the first part of the formula, the plan must provide for payments of at least $50 per month to unsecured nonpriority creditors who are not insiders. The second part of the formula defines "monthly net income" for purposes of a Chapter 13 plan, and creates a mechanism for requiring that "the total amount of monthly net income" is paid to unsecured nonpriority creditors during the minimum plan period, less only expenses of administering the case.

The definition of "monthly net income" created by 102 is similar to "projected monthly net income" established under 101—it starts with total monthly income and deducts standard expense allowances to be determined by the Internal Revenue Service, with the potential for adjustment if the debtor has extraordinary expenses or loss of income. In contrast to 102 of H.R. 2500, secured debt and priority debt are also deducted from net income.

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To assure that all monthly net income is paid through a plan to unsecured nonpriority creditors (and administrative claimants), 102 requires that the debtor itemize extraordinary expenses or loss of income in a statement sworn to by the debtor and the debtor's attorney. The debtor's statement of extraordinary expenses could be challenged by objection, and the prevailing party in a hearing on the objection could be awarded fees and costs. If the debtor files such a statement, the statement must be refiled, to reflect current conditions, no less than annually during the duration of the plan. All Chapter 13 plans would also be required to provide that future net monthly income will be paid as reasonably determined by the Chapter 13 trustee, with at least annual reviews to determine whether net income has increased or decreased. [This last provision is inconsistent with 101 of the proposed bill. As noted above, 101 imposes a duty of the Chapter 13 trustee to report annually to the court as to whether any increases or decreases in the debtor's net income should result in modification of the debtor's plan. Under the terms of 102, increases or decreases in the debtor's net income, as determined by the trustee, would automatically result in changes in payments to creditors, without plan modification.]

THE IMPACT. Three substantial impacts that can be anticipated as a result of the changes made in 102 of the bill:

Plan length. The new five-year minimum plan length would be arbitrarily imposed, depending on size of household. This new plan length is required whenever the debtor's household income is at least 75% of the median household income determined by the Census Bureau, according to the number of persons in the debtor's household. As discussed

above, in connection with 101, median income varies erratically with the number of persons in the household. Single individuals would be required, using currently available census figures, to propose a five-year minimum plan whenever their gross annual income was at least $13,819.50, but the trigger point for a married couple would be $29,279.25. Individuals in a household of four would not face the five-year minimum until their household income reached $40,278; but in a household of six, the five-year minimum would be triggered by income of $33,586.50.

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Where the five-year minimum plan length is imposed, it may increase payments to general unsecured creditors; however, the longer length can be expected to increase the number of cases that fail for default in payment. A five-year minimum term may also have the effect of discouraging any Chapter 13 filing, giving debtors additional incentive for prebankruptcy planning to meet the proposed new filing requirements for Chapter 7. As discussed above in connection with 101, these limitations may be met by increasing debt and decreasing income prior to filing.

The substitution of "net income" for "disposable" income. Current law requires Chapter 13 debtors to contribute all of their disposable income to the Chapter 13 plan, and, after payment of secured and priority claims, this income would be used to pay general unsecured creditors. Disposable income is very generally defined in the Code (1325(b)(2)), and courts have varied in their interpretation. The proposed change would require that all of a debtor's "net" income be used to pay general unsecured creditors. Because secured priority claims are deducted from the calculation of net income, the principal difference introduced by the proposed legislation is that standard expense allowances would be determined, in the first instance, by the IRS—rather than by the courts—subject to individualized exceptions, reviewed annually. This process could reduce the arbitrariness associated with the disposable income test; for this reason, some use of general guidelines for determining appropriate levels of Chapter 13 plan contributions has been recommended by the National Bankruptcy Review Commission. National Bankr. Review Comm'n, Bankruptcy: The Next Twenty Years 262–73 (1997) ("Final Report"). However, the process of IRS rule-making, followed by individual determinations of exceptions, will involve substantial cost, as noted in the discussion of 101, above.

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Minimum monthly payments of $50 to general unsecured claims of noninsiders. The $50 minimum payment to general unsecured creditors, proposed by 102, applies to all Chapter 13 debtors, even those who have no net income, or less than $50 in net income. This minimum payment may make Chapter 13 unavailable, or at least discourage its use, by lower income debtors.

The situation of low or nonexistent net income is common in Chapter 13—for example, debtors emerging from a divorce may have very great difficulty in making both required support payments and mortgage payments. In order to save their homes or automobiles, Chapter 13 debtors are often willing to attempt to live on substantially less than what would be considered as an appropriate level of expense for necessities. Plans proposing food budgets of $100 for a family of four are not uncommon, with all or almost all of the plan payments going to secured or priority creditors. The $50 minimum for unsecured debt may render such marginal plans completely impossible.

A second problem exists for lower income debtors who owe unsecured debts both to family members and others. Section 102 would require that the first $50 of every monthly payment go to the nonfamily members (since family members are insiders). The $50 minimum thus provides substantial incentive for debtors with low net income to choose Chapter 7, where all of their debts will be discharged, so that they can repay debts owing to family members voluntarily.

ALTERNATIVE. As suggested by the National Bankruptcy Review Commission, the objective of obtaining payment for general unsecured creditors might be advanced by requiring that payments proposed for general unsecured claims in a Chapter 13 plan be made in equal installments throughout the plan, rather than paid only after secured and priority claims. See Final Report at 262.

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103 ("Definition of inappropriate use") (see H.R. 2500, 115; S. 1301, 102)

THE CHANGES. This section makes five changes to 707(b) of the Bankruptcy Code. Section 707(b) currently allows for dismissal of Chapter 7 cases that are a "substantial abuse" of the provisions of Chapter 7. Section 103 of H.R. 3150 would change the operative term from "substantial abuse" to "inappropriate use." Next, the section would require a finding of "inappropriate use" if the debtor is disqualified from Chapter 7 filing by the "ability to pay" provisions of 101, discussed above, or if "the totality of circumstances of the debtor's financial situation demonstrates such inappropriate use." The third change made by this section would be allowing creditors and Chapter 7 trustees to bring motions to dismiss Chapter 7 cases based on substantial abuse. Currently motions under 707(b) can only be brought by the United States Trustee or the court. Fourth, the section would allow conversion to Chapter 13, with the debtor's consent, as an alternative to dismissal of the bankruptcy case. Finally, the section would allow the court to award fees and costs against a creditor who brought a motion seeking dismissal for substantial abuse, upon a finding by the court that the allegations of the motion were unsubstantiated.

THE IMPACT. The proposed changes principally provide a means of enforcing the limitation on Chapter 7 relief proposed in 101 of the proposed bill. Current law limits the right to bring 707(b) motions based on the understanding that debtors should generally be able to choose to obtain an immediate fresh start when they are in financial difficulty, and this understanding would be changed by 101, as discussed above. If creditors are allowed to bring motions for substantial abuse, the fee shifting provision may help to reduce creditor motions brought merely to exert leverage on debtors. Just as current law does not define "substantial abuse," the proposed change would retain a large degree of discretion by allowing courts to grant relief based on the "totality of circumstances." The option of conversion to Chapter 13 would usually exist under present law, pursuant to 706(a), which generally gives a Chapter 7 debtor the option of converting the case to Chapter 13 "at any time."

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Subtitle B ("Adequate Protections for Consumers")

111 ("Notice of alternatives") (see H.R. 2500, 103; S. 1301, 301).

THE CHANGES. The major change involved in 111 is to assure that each consumer bankruptcy debtor is given a written notice that both discusses the option of consumer credit counseling and lists credit counseling services with offices in the district in which the bankruptcy is filed. The list would be prescribed by the United States Trustee and questions about whether a particular counseling service should be included in the list would be determined by the court.

THE IMPACT. This proposal can result in relevant information being made available to debtors, although it is likely that debtors consulting an attorney will place more weight on the attorney's advice than on the information in a form given to them by the attorney. The proposal will probably have the greatest impact on pro se filers. Difficulties may exist in describing the services available from credit counselors, at least if the description includes any comparison of credit counseling and bankruptcy in satisfying debt or in maintaining or reestablishing credit. The need to administer the list of credit counselors will involve some additional cost to the United States Trustee.

112 ("Debtor Financial Management Training Test Program") (new)

THE CHANGES. This section of H.R. 3150 would require the Executive Office of the United States Trustee (1) to develop a program to educate debtors on the management of their finances, (2) to test the program for one year in three judicial districts, (3) to evaluate the effectiveness of the program during that period, and (4) to submit a report of the evaluation to Congress within three months of the conclusion of the evaluation. The test program is to be made available, on request, to both Chapter 7 and 13 debtors, and, in the test districts, bankruptcy courts could require financial management training as a condition to discharge.

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THE IMPACT. Debtor financial education was a recommendation of the National Bankruptcy Review Commission, but the Commission did not recommend any methodology for implementing it. See Final Report at 114–16. There are two potential problems with the methodology suggested here. First, one year may not be a long enough time to assess the effectiveness of any program. Success in financial management would be indicated by such factors as completion of a Chapter 13 plan, ability to reestablish high quality credit, and (most importantly) avoidance of further financial overspending. None of these bench marks can be assessed after one year. Second, the power to compel debtor education as a condition for discharge is accorded without specifying the circumstances in which it should be exercised, with the potential for widely varying application. Some judges might require debtor education in all consumer cases, while others never require it. Compulsory education in pilot districts also would be subject to constitutional challenge, as nonuniform bankruptcy legislation. See *Railway Labor Executives' Assn.* v. *Gibbons*, 455 U.S. 457, 469–71 (1982) (invalidating bankruptcy legislation that applied to a single railroad).

ALTERNATIVES. A study could be conducted of the effectiveness of the existing debtor education programs, based on their past experience. Compulsory education should be imposed only after an education program is available nationwide, and should be imposed only in situations defined by law.

113 ("Definitions") (new)

114 ("Disclosures") (new)

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115 ("Debtor's Bill of Rights") (new)

116 ("Enforcement") (new)

THE CHANGES. These four sections of H.R. 3150 set up a new system for regulating the providers of consumer bankruptcy services. Section 113 defines the term "debt relief counseling agency" to include both lawyers and non-lawyer providers of consumer bankruptcy goods or services, and the remaining sections establish regulations bearing on these providers. Section 114 would place a new 526 in the Bankruptcy Code, imposing a set of disclosure obligations on consumer bankruptcy providers. The disclosure would include (1) the availability of consumer credit counseling services, (2) the need for a truthful listing of assets and income in bankruptcy, subject to audit and criminal sanctions, (3) the obligation of the provider to issue a contract specifying the services that will be provided and their cost, together with a specification of the services that might be needed, and (4) directions on how to complete bankruptcy schedules. Copies of the first two of these notices would be required to be maintained by the provider for two years after the notice is given, or two years after a discharge is received, whichever is longer.

Section 115 would add a new 527 to the Code, with further regulation of consumer bankruptcy providers. It would require a written contract for bankruptcy-related services, with a copy for the client, and specify that the advertising of consumer bankruptcy providers include a conspicuous disclosure that they are engaged in bankruptcy filing. Finally the section would prohibit consumer bankruptcy providers from (1) failing to perform promised services, (2) negligently making or counseling to be made any false statement in a bankruptcy filing, (3) misrepresenting the services to be provided, or the benefits or detriments of bankruptcy, and (4) advising the incurring of debt to pay for bankruptcy related services.

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Section 116 would enforce the new regulations on consumer bankruptcy providers. It provides debtors may not waive the provisions of "section 526" and that contracts not complying with "section 526" are void. [This is apparently a drafting error, since proposed 526 governs notices, while proposed 527 governs the content of contracts and the performance of services on behalf of debtors.] The section would further impose sanctions on consumer bankruptcy providers who engage in prohibited conduct. There is a mandatory sanction of loss of all fees previously paid by the

debtor, and a potential sanction of being required to continue the representation of the debtor without further fees. The prohibited activities include intentional or negligent failure to comply with any applicable requirement of the Code or the Federal Rules of Bankruptcy Procedure applicable to consumer bankruptcy providers, and providing assistance to a debtor whose case is dismissed or converted under 707(b), or dismissed for failure to file bankruptcy papers. The section would allow enforcement of the provisions of 526 by officials of state government, in either federal or state court, with actual damages awarded to the debtors affected, and with the consumer bankruptcy provider required to pay the costs and fees of any successful enforcement action. Finally, the section specifies that its provisions do not supersede any state regulation of consumer bankruptcy services except to the extent of any inconsistency.

THE IMPACT. It is questionable whether the proposed regulation would have any significant positive impact on the provision of bankruptcy services. The likely impact of the new regulations imposed by H.R. 3150 on the providers of consumer bankruptcy services can be divided into three classes.

First, some of the requirements merely reiterate existing obligations or good practices. In this category are the obligations (1) to provide written contracts specifying the services to be performed and their cost and (2) to perform the promised services. (Fees and services of petition preparers and attorneys are presently regulated by 110, 329, and 330 of the Code.)

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Second, some of the requirements appear to impose unnecessary costs on the providers. For example, the requirement to retain copies of each notice provided to a client or prospective client for at least two years involves substantial cost with no apparent benefit. Similarly, the requirement of "conspicuous notices" in all advertisements would impose unnecessary costs in connection with classified advertisements and telephone directories.

Third, some of the regulations may have a chilling effect on the provision of consumer bankruptcy services. For example, the automatic denial of fees in any case dismissed under 707(b) can be expected to discourage attorneys from filing Chapter 7 cases in situations where eligibility for Chapter 7 relief was questionable. Similarly, automatic denial of fees in cases dismissed for failure to file documents may discourage attorneys from filing cases whenever the debtor's ability to produce documents is doubtful. Finally, the provision that a provider may never counsel borrowing to pay for bankruptcy fees is overbroad, prohibiting appropriate advice necessary to permit a bankruptcy filing. While a debtor should never be counseled to borrow money fraudulently, with the intent of discharging the debt, it may be entirely appropriate to enter into a secured loan for the purposes of financing a bankruptcy filing, and a loan from a friend or relative (intended to be repaid despite the discharge) may also be proper.

ALTERNATIVE. Where it is found that providers of consumer bankruptcy services are engaged in specific misconduct that is not adequately addressed by existing law, the current provisions of the Code can be amended to sanction that misconduct. For example, if it is found that bankruptcy providers are misrepresenting their services as not involving bankruptcy, that misconduct could be specified as a ground for refund of fees under 329 of the Code (with punitive damages, if appropriate).

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Subtitle C ("Adequate Protections for Secured Lenders").

121 ("Discouraging bad faith repeat filings") (see H.R. 2500, 109; S. 1301, 303).

THE CHANGES. This section provides (1) that the automatic stay will terminate after 30 days in cases of repeated bankruptcy filings within one year, unless a party in interest demonstrates that the filing of the later case was in good faith, and (2) that the bankruptcy court have discretion to enter orders granting relief from the stay "in rem," providing that the automatic stay will not apply in subsequent cases filed by the same debtor or in cases filed by other parties with specified knowledge of the order.

THE IMPACT. The role of the automatic stay differs substantially in Chapter 7 and in Chapter 13. In Chapter 7, the stay has the effect of allowing a trustee to determine whether property of the debtor should be liquidated for the benefit of creditors. For example, a home that is about to be sold in a foreclosure sale, might, in the trustee's judgment, be able to be sold by a broker for a higher price, sufficient to pay the mortgage and have a surplus for distribution to unsecured creditors. The automatic stay prevents a foreclosure from taking place in a situation like this, while allowing the mortgagee to seek relief from the stay by showing that there is in fact no equity in the property. In Chapter 13, the automatic stay has the effect of allowing a debtor to propose and carry out a plan that deals with secured claims in such a way that the debtor is allowed to retain the collateral, even if there is no equity. A debtor who has no ability to deal with a secured claim properly in Chapter 13 may nevertheless file repeated bankruptcy cases in order to prevent a foreclosure or repossession from going forward, by invoking the automatic stay repeatedly. The proposal seeks to limit debtors' ability to use this tactic, and many of its features would be helpful. However, the proposed changes do not reflect the different roles that the automatic stay plays in Chapter 7 and Chapter 13, and thus may have unintended consequences.

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In Chapter 7 cases, regardless of whether there was a prior case, the issue involved in application of the automatic stay should be limited to the question of equity. To allow the automatic stay to remain in effect, a Chapter 7 trustee should simply be required to show that there is equity in the property at issue; the good faith of the debtor in filing the case is not relevant. To see the problem with the proposal in this connection, consider the following example: a debtor with limited income has taken out a home equity loan on the family home, and cannot keep up with the payments. The lender files a foreclosure action, and the debtor seeks to save the home in Chapter 13, but fails to make plan payments, so that the bankruptcy case is dismissed and the foreclosure action is recommenced. This time, again to stop the foreclosure, the debtor files a Chapter 7 case. There is considerable equity in the home. Under the proposal, there is a presumption (since the debtor failed to make plan payments) that the second case is filed in bad faith, and if the Chapter 7 trustee wants to keep the automatic stay in effect beyond 30 days, the proposal would require the trustee to establish, by clear and convincing evidence, that the case was filed in good faith. If the trustee is unable to do so, the foreclosure will go forward, and the estate will lose the higher value that could have been obtained in a brokered sale.

On the other hand, the good faith standards set out in the proposal are reasonably applicable to Chapter 13 cases, requiring that the debtor establish good faith for repeatedly invoking the automatic stay.

The impact of the "in rem" provision is difficult to determine, because no standards are set out for the entry of in rem orders. These orders would be most appropriate as applied to property in which there was no equity, and as to which there had been a pattern of bankruptcy filings. In such situations, the orders could help to prevent debtor abuse. In other situations, the orders might again prevent sales by Chapter 7 trustees to the benefit of unsecured creditors. Also, the proposal does not state whether the court would be authorized to vacate an in rem order in a subsequent case upon a showing that the case was filed in good faith. Absent such specification, there may substantial litigation to determine the issue.

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ALTERNATIVES. The 30-day termination of the automatic stay should be postponed in Chapter 7 cases upon a request by the trustee for a hearing on the question of equity. In rem orders for relief from stay should be limited to situations in which there is no equity in the property and in which the property has been the subject of more than one bankruptcy filing.

122 ("Definition of household goods and antiques") (see H.R. 2500, 119).

THE CHANGES. The proposed legislation would add a definition for "household goods" to the definitions of 101 of the Code. "Household goods" are a category of debtors' assets that may be exempted under 522(d), and as to which certain liens may be avoided under 522(f). The proposal would define "household goods" by incorporating the definition that appears in 16 C.F.R. 444.1(i). That regulation of the Federal Trade Commission defines "household

goods" as:

Clothing, furniture, appliances, one radio and one television, linens, china, crockery, kitchenware, and personal effects (including wedding rings) of the consumer and his or her dependents, provided that the following are not included within the scope of the term "household goods": (1) Works of art; (2) Electronic entertainment equipment (except one television and one radio); (3) Items acquired as antiques; and (4) Jewelry (except wedding rings).

Although the heading of the proposed section mentions antiques, no definition of "antiques" is given in the text.

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THE IMPACT. Section 522(f) allows the avoidance of nonpurchase money, nonpossessory liens on certain items of exempt household property. The idea underlying this provision is that when a lender extends credit on the basis of used household goods in the possession of the debtor, it is unlikely that there would be any substantial resale value in the collateral, and that the lender is primarily relying on the difficulty that the debtor would face in replacing the items. The Bankruptcy Code made the determination that such liens should not be enforced. It appears to be the intent of the proposed legislation to strictly limit the type of property that may be excluded from nonpossessory, nonpurchase money security interests. The Trade Commission definition of household goods would exclude such common items as home computers, CD players, speaker systems, earrings, and framed prints. If so, it would be unduly restrictive. To some extent, the limitations of the FTC definition would not restrict 522(f), because "household goods" is only one of the categories of personal property as to which liens may be avoided under that subsection. Other categories include "household furnishings," and "jewelry." The major impact of the change may be to give rise to new litigation as to whether particular items not within the FTC definition of "household goods" constitute "household furnishings."

ALTERNATIVE. In order to protect nonpurchase money lenders who genuinely rely on the value of the debtor's personal property in extending credit, Section 522(f) could be amended to exclude from lien avoidance any items of personal property not within the FTC definition whose resale value exceeds a specified amount (for example, $1000).

123 ("Debtor retention of personal property security") (see H.R. 2500, 112).

THE CHANGES. Some courts have held that debtors in Chapter 7 may redeem personal property in installments. The proposed change would require that redemption take place by payment in full at the time of redemption. In addition, this section proposes that if the debtor does not redeem personal property that is collateral for a claim, or enter into a reaffirmation agreement with respect to the property, that the property will be deemed abandoned by the Chapter 7 trustee, so that the creditor may repossess the property or take other action allowed by nonbankruptcy law.

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THE IMPACT. Although debtors rarely have equity in personal property that is collateral for debt, there can be situations where equity does exist, as in jewelry or luxury cars. This proposal, perhaps unintentionally, would remove property from the estate even if there was equity in the property. As applied to property in which there is no equity, the impact of the proposal would be to create an appropriate incentive in favor of Chapter 13 filings whenever a debtor wished to retain property that could not be redeemed, and as to which a reaffirmation agreement could not be negotiated.

ALTERNATIVE. The proposal should be amended to allow a trustee to require that abandonment take place only after notice to the Chapter 7 trustee, with an opportunity for the trustee to be heard on the question of whether there is equity in the property.

124 ("Relief from stay when the debtor does not complete intended surrender of consumer debt collateral") (see H.R. 2500, 208).

THE CHANGES. Section 521(2) of the Bankruptcy Code currently requires Chapter 7 debtors to make an election

as to their property which serves as collateral for consumer debts: they must indicate that they intend to retain or surrender the property, and "if applicable" state that the property is claimed exempt, that the debtor intends to redeem the property, or that the debtor intends to reaffirm the debts secured by the property. The law further indicates that the debtor is obligated to carry out the specified choice within 45 days of filing its notice of the election as to the property involved. Section 124 of the H.R. 3150 would make a number of changes in the operation of this provision:

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(1) The section would be made applicable to all collateral, not merely collateral securing consumer debts.

(2) The time for performing the election would be changed from 45 days after the filing of the notice to "30 days after the first meeting of creditors under section 341(a)."

(3) The option for retaining the property and claiming it as exempt is eliminated, so that the only options given the debtor for collateral are: (1) surrender, (2) redemption, and (3) reaffirmation or lease assumption.

(4) A failure by the debtor to timely perform its election would result in termination of the automatic stay as to the property involved unless the debtor chose reaffirmation and the creditor refused to reaffirm on the original contract terms.

(5) If the automatic stay terminates pursuant to the above provisions, it is specified that the creditor should be allowed to proceed with any state law remedies for default based on the filing of the bankruptcy. Thus, the fact that the debtor was current in payments would not be grounds to prohibit repossession or foreclosure if state law allowed these remedies based on the filing of a bankruptcy. This provision would not be applicable as to property for which a lien was avoided in the bankruptcy case. [In this connection, there appears to be drafting error: including 553 of the Code in a list of sections under which a lien might be avoided. Section 553 terminates certain setoffs, which can function like liens in some circumstances, but the provisions of 521(2), sought to be enforced by this proposal, have nothing to do with setoffs.]

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THE IMPACT. Current law has no enforcement mechanism for 521(2), and this section provides the most reasonable enforcement mechanism—relief from the automatic stay. Similarly, expressly allowing repossession based on the bankruptcy filing (if permitted by state law) addresses the creditor's concern that the collateral will not be maintained once the debtor is no longer personally liable for any deficiency. However, the proposal does not deal with the situation in which there may be equity in the property. Thus, in the situation of a home mortgage where there is equity in the property, the failure of the debtor to comply with the requirements of 521 results in relief from the automatic stay with no opportunity for the trustee to oppose that relief.

Moreover, the proposal would interfere with the debtor's option to retain exempt property without reaffirmation or redemption. Debtors are allowed by 522(f) of the Code to avoid liens on certain exempt personal property secured by nonpossessory, nonpurchase money security interests. A requirement that the debtor surrender, redeem, or reaffirm debt as to this property would contradict this lien avoidance provision. Under the proposal, the automatic stay would terminate as to property exempted under 522(f) when the debtor failed to redeem or reaffirm the debt, even though no discharge had yet been granted the debtor. The debtor would presumably have a defense of lien avoidance if the creditor pursued state law remedies as to the property in question, but there is no reason why the automatic stay should not remain in effect.

A final difficulty with the proposal is its ambiguity in establishing the date by which a debtor must make the 521(2) election. The language "30 days after the first meeting of creditors under section 341(a)" might mean (1) 30 days after the first date set for the meeting (see Fed.R.Bankr.P. 3002(c)), (2) 30 days after the date on which the meeting is actually commenced, or (3) 30 days after the meeting is concluded (see Fed.R.Bankr.P. 4003(b)). This ambiguity, if uncorrected, can be expected to generate litigation.

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ALTERNATIVES. Failure by debtors to exercise their obligations under 521 could be made grounds for relief from the automatic stay, but relief awarded only on notice to the trustee. Relief would not be awarded where there is equity in the property and the trustee wishes to sell the property. The provision should also include as an option the retention of property with lien avoidance under 522(f), and should specify that the debtor must make the election within 30 days from the first date set for the creditors' meeting.

125 ("Giving secured creditors fair treatment in Chapter 13") (see H.R. 2500, 105; S. 1301, 302).

THE CHANGES. Current case law interpreting Chapter 13 is in disagreement about the time at which a lien should be deemed released under a plan. This provision would resolve the dispute by amending 1325 of the Code to state that a lien can only be released at the time the debtor is discharged under section 1328, or until the claim secured by the lien is fully paid, whichever is earlier. The provision also states that, in the event of conversion or dismissal of a Chapter 13 case, the lien would remain to the extent recognized under nonbankruptcy law.

THE IMPACT. This change would primarily affect automobile loans. Frequently an auto loan in a Chapter 13 case is in an amount greater than the value of the automobile. In such a case, the debtor is allowed to pay the value of the car in satisfaction of the secured claim, with the balance of the claim treated as unsecured. The plan may provide that as soon as the secured portion of the claim is satisfied, the creditor is required to release its lien. Thereafter, the debtor may fail to complete the plan, so that the creditor does not receive full payment of the unsecured portion of its claim. This provision would allow the creditor to retain its lien to secure payment of that unsecured portion.

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The provision contradicts the bankruptcy policy requiring equal treatment of creditors. To the extent that a secured creditor has a claim not supported by collateral value, the Bankruptcy Code treats the creditor's claim as unsecured, and entitled to the same treatment as other unsecured claims. This provision would allow the unsecured portion of a secured claim a preferential position—even though the value of its secured claim was paid, the creditor would be able to take action against property of the debtor to enforce its unsecured claim, a right that no other unsecured creditor would have.

The effect of conversion or dismissal of a Chapter 13 case is treated in separate provisions of the Bankruptcy Code, 348 and 349. See 127 of H.R. 3150, discussed below. If changes are made regarding the effect of conversion or dismissal and not placed in those sections, there will be a question as to which section controls.

ALTERNATIVES. Payments on account of unsecured claims could be required to be made in equal installments throughout a plan, so that the unsecured portion of a bifurcated claim is paid during the same time that the secured portion is paid, and all unsecured claims are treated in the same way. Changes in the effect of conversion or dismissal should be made in 348 and 349 of the Code.

126 ("Prompt relief from stay in individual cases") (see H.R. 2500, 207; S. 1301, 311).

THE CHANGES. This section would provide that in individual bankruptcy cases under Chapters 7, 11, or 13, the automatic stay would terminate 60 days after a request for relief from the stay, unless (1) the court denies the motion, or (2) all parties in interest agree to a continuance of the stay beyond that time, or (3) the court makes a finding that continuance of the stay is required by compelling circumstances.

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THE IMPACT. This provision does not substantially change existing law, which requires that all motions for relief from stay must be heard initially within 30 days, and that if the initial hearing is not final, the final hearing must commence within 30 days after the conclusion of the preliminary hearing. This section would only apply in cases of

hearings lasting more than one day, which are very unusual in consumer cases. Both present law and the proposal allow extensions by the court for compelling circumstances.

127 ("Stopping abusive conversions from Chapter 13") (see H.R. 2500, 108; S. 1301, 310).

THE CHANGES. This section of the proposed legislation has two parts. First, under 348(f) of the Bankruptcy Code, when a debtor converts a Chapter 13 case to a case under Chapter 7, the valuation of allowed secured claims is carried over from the Chapter 13 case to Chapter 7, with the amount of the secured claim reduced by whatever payments were made on account of that claim to the secured creditor. The proposed bill would change this result, providing that to the extent any amount remains owing to the secured creditor at the time of the conversion, the entire amount owed will be secured by the collateral. Second, the section provides that, to the extent that any default in payments is not fully cured, the default "shall have the effect given under applicable nonbankruptcy law." [Note: This section of the proposed bill contains a drafting error. Section 348(f) of the Bankruptcy Code applies to all cases converted from Chapter 13 to other chapters of the Code. Section 108 is intended to leave the terms of 348(f) in place as they apply to Chapter 13 cases converted to Chapter 11 or 12, and then set out new terms, in a new subsection 348(f)(C), for cases converted from Chapter 13 to Chapter 7. Thus, the new subsection should have been introduced by the phrase "with respect to cases converted to Chapter 7." Instead, the new subsection is introduced by the redundant and confusing phrase "with respect to cases converted from Chapter 13."]

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THE IMPACT. The first proposed change has a very narrow impact. In Chapter 7, pursuant to the Supreme Court's decision in *Dewsnup* v. *Timm*, 502 U.S. 410 (1992), a debtor cannot simply pay the secured portion of any secured creditor's claim and retain the collateral. Rather, a Chapter 7 debtor can only exercise this right in the context of a redemption, pursuant to 722 of the Code. This section allows a debtor to pay the amount of the "allowed secured claim" in order to redeem "tangible personal property intended primarily for personal, family or household use, from a lien securing a dischargeable consumer debt, if the property is exempted . . . or has been abandoned." When a case is converted from Chapter 13 to Chapter 7, a question may arise as to how much is required to be paid by the debtor in order to redeem tangible personal property, such as an automobile. Current law provides that the amount of the secured claim, fixed during the Chapter 13 case at the value of the collateral, continues to be the amount of the secured claim for purposes of the case on conversion to Chapter 7, and that any payments made on account of the secured claim during the Chapter 13 case reduce the claim on conversion. For example, if the debtor owed $10,000 on a car loan at the outset of a Chapter 13 case, and the car was valued by the court at $7,000, the lender would have had a secured claim of $7,000 in the Chapter 13 case and an unsecured claim of $3,000. If the debtor paid $2,000 on the secured claim through the Chapter 13 plan, and then converted the case, current law would provide that, on conversion, the lender had a secured claim of $5,000 (the original $7,000 claim reduced by the $2,000 payment). Thus, if the debtor wished to redeem the automobile in Chapter 7, the price for redemption would be $5,000, even if the car was worth more than that amount at the time of redemption. Under the proposed change, the intent appears to be that the creditor would have an $8,000 claim secured by the automobile (the total claim of $10,000 less the $2,000 paid during the Chapter 13 plan). In order to redeem, the debtor would then have to pay the entire value of the automobile, up to $8,000. In this way, the secured creditor could receive, as a price for redemption, a total compensation greater than the value of the collateral at the time of the filing of the case.

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The second provision of the section, dealing with the cure of default, is unclear. Under nonbankruptcy law, a default gives secured creditors certain rights to the collateral, which may include immediate repossession or commencement of a foreclosure action. In a Chapter 7 bankruptcy, those rights are stayed. It may be that this provision is intended to terminate the automatic stay in a case converted from Chapter 13 to Chapter 7 whenever there is an uncured default. If so, the provision would violate the principle that the Chapter 7 trustees are allowed to sell property in which there is equity, for the benefit of all creditors. This would not appear to be a reasonable provision, but no other meaning is apparent.

ALTERNATIVES. Bad faith conversion from Chapter 13 is currently penalized by 348(f)(2), which provides that the Chapter 7 trustee in the converted case may liquidate all of the nonexempt property in the possession of the debtor at the time of conversion. This penalty could be made more effective by uniform exemption laws. Another alternative would be to allow denial of conversion in situations of bad faith.

128 ("Restraining abusive purchases on secured credit") (see H.R. 2500, 110).

THE CHANGES. This section of the proposed bill would change the bifurcation of any secured claim resulting from the debtor's incurring secured credit within 180 days of the bankruptcy filing. Instead of the secured creditor having a secured claim only to the extent of the value of its collateral, with an unsecured claim for the difference, the secured creditor would be given a secured claim in the amount of the entire indebtedness outstanding at the time the bankruptcy was filed. If the creditor is also secured by other property, purchased more than 180 days prior to the bankruptcy, the claim would be bifurcated, but the resulting secured claim could not be less than the debt outstanding as a result of the purchase made within the 180 day period.

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THE IMPACT. The section is not limited to situations of bad faith purchases—it applies in any case in which the debtor files bankruptcy after making a credit purchase. For example, if a debtor purchased an automobile in January, was laid off in February, and filed bankruptcy in May, this provision would result in a change in the operation of the Bankruptcy Code with respect to the claim secured by the automobile. In Chapter 7, one impact of this provision is to increase the cost of redemption. Instead of paying the value of the collateral at the time of redemption, the debtor would be required to pay the entire outstanding indebtedness. Another impact is to reduce the recovery of the secured creditor in any Chapter 7 case where there is a distribution. Under existing law, any secured creditor would be viewed as having a secured claim to the extent of the value of the collateral, and an unsecured claim for the difference between the value of the collateral and the total claim. Thus, in the example given above, if $25,000 was the outstanding loan balance, and the car valued at $20,000, current law would allow the creditor both to repossess the car and have a $5000 unsecured claim, payable through sale of the debtor's other assets. Under the proposal, the creditor's claim would be treated as fully secured, and repossession would be the sole recovery.

In Chapter 13 cases, the impact of this provision would be to prevent "strip down" of the affected secured claim. As a result, a greater portion of the debtors' contributions to the Chapter 13 plan would go to pay the secured claim, and a smaller amount would be paid to unsecured creditors. For example, an automobile purchased six months before a bankruptcy may have substantially depreciated. If the automobile was purchased at a high interest rate with a long amortization, the amount owing on the car at the time of the bankruptcy may be close to the original purchase price. If the debtor missed one or more payments, the debt may exceed the original purchase price. The proposal would require that the debtor, in order to retain the automobile, pay the total amount due, rather than what the car was worth. Assuming that the debtor plan makes less than full payment of all claims, the effect is to increase the amount paid on the auto loan and reduce the amount paid to other creditors.

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ALTERNATIVES. Current law allows both Chapter 7 and Chapter 13 cases to be dismissed for lack of good faith. The Code could be amended to provide that a case shall be dismissed for lack of good faith where a debtor is shown to have made a purchase on secured credit with the intent of filing bankruptcy shortly thereafter.

129 ("Fair valuation of collateral") (see H.R. 2500, 111).

THE CHANGES. This provision of the proposed bill would amend the claim bifurcation provision of the Bankruptcy Code (506(a)) to provide that collateral in Chapter 7 and 13 cases is always valued at the cost to replace the property, without deducting the costs of sale or marketing, and that this replacement cost, for property "acquired for personal, family, or household purpose" is "the price a retail merchant would charge for property of that kind."

THE IMPACT. The impact of this proposal differs, depending on whether it is applied in Chapter 7 or in Chapter 13. In Chapter 7, the most common reason for bifurcating a claim is in redemption: a debtor is allowed, in Chapter 7, to retain personal property that cannot be sold for the benefit of unsecured creditors (because there is no equity in the property, or because it is exempt), by paying any creditors secured by the property the amount of their allowed secured claims. In this way, instead of obtaining the property, as they would by repossession, the secured creditors receive the value of the property, which may be less than the total amount owed. To the extent that the creditors receive less than the total amount they are owed, they are given an unsecured claim for the difference. Under current law, there is no explicit direction as to how to value the collateral being retained by the debtor. However, since redemption is a substitution for return of the collateral, there is no apparent reason why secured creditors should receive, in a redemption, any more than they would receive if they did repossess the collateral. Valuing the collateral at the price it would cost the debtor to replace it gives an arbitrary increase in collateral value to the secured creditor, with the amount of the increase depending on how expensive it would be for the debtor to replace the property involved. Using retail price as the measure for replacement cost exacerbates this problem, since, as the Supreme Court noted in its recent Rash decision, retail price may include "items such as warranties, inventory storage, and reconditioning," that are in no sense part of the collateral that secures a creditor's claim. *Associates Commercial Corp.* v. *Rash*, 117 S.Ct. 1879, 1886 n.6 (1997). Finally, in the context of redemption, the creditor has no risk of nonpayment, and so there is no reason for any increase in the amount of the secured claim to compensate for risk of nonpayment.

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In Chapter 13, the principal reason for bifurcation is in "stripping down" liens to the value of the collateral and paying the reduced secured claim over the course of the plan. Here, the impact of bifurcation is to divide the plan payments between secured and unsecured creditors. The debtor must either pay all claims in full (including the unsecured portion of a secured claim) or else must pay all disposable or "net" income into the plan. To the extent that a secured claim is valued at a higher level, less of the plan payments will go to unsecured creditors. So, in this context, "fairness" requires a balancing of the rights of secured and unsecured creditors. Again, the value of collateral to a secured creditor is best measured in terms of what that creditor could get for the collateral. To the extent that the creditor could only obtain part of what is owed from the collateral, the creditor is best seen as unsecured, just like the other unsecured creditors, regardless of how much it might cost the debtor to replace the property. In contrast to redemption, however, the secured creditor in Chapter 13 does not receive immediate payment of its claim, and so the creditor does have a risk of nonpayment. This can be addressed by amending the Code to provide that payments of secured claims in Chapter 13 plans should carry an interest rate sufficient to offset the risk of nonpayment.

A final difficulty with the proposal is that many items of collateral (unlike automobiles) do not have an established retail market for used items. For example, a creditor may be secured by a five year old washing machine. There are unlikely to be readily ascertainable retail markets for such machines. The proposal would leave no guidance as to the proper valuation method in this situation.

ALTERNATIVE. To create a fair valuation of collateral, the Code could be amended to provide that a secured creditor receive a secured claim in the amount that the creditor could establish that it would receive using any method of sale available to the creditor. If the claim is not paid immediately, the creditor should receive an interest rate on the secured claim sufficient to offset the risk of nonpayment. A similar standard of valuation has been proposed by the National Bankruptcy Review Commission. Final Report at 243–58.

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130 ("Protection of holders of claims secured by debtor's principal residence") (see H.R. 2500, 120).

THE CHANGES. Section 130 of H.R. 3150 would (1) provide that a claim is not subject to modification if it is secured "primarily" (rather than "only") by a lien on property used as the debtor's principal residence at any time during the 180 days prior to the bankruptcy, (2) define "debtor's principal residence," and (3) exclude continuances of mortgage foreclosures from the operation of the automatic stay.

THE IMPACT. These changes largely resolve conflicts in the case law respecting the treatment of home mortgages in Chapter 13. Section 1322(b)(2) provides that, generally, secured claims can be modified in Chapter 13. This allows the plan to pay, as a secured claim, only the value of the collateral. To protect lenders of home mortgages, the right to modify is denied when the lender is secured only by a mortgage on the debtor's principal residence. Some decisions have held that a multi-unit building would constitute security other than the debtor's principal residence, or that a mobile home would not be a residence. The proposed change would include loans on such property within the scope of the protection. Similarly, there have been reports of situations in which debtors have vacated their homes shortly before filing Chapter 13 cases, so as to remove the protection given to the mortgage lender. The proposal negates such a tactic by applying the protection to homes used as the debtor's principal residence during a 180 day period prior to the bankruptcy.

A final issue regarding the application of the non-modification provision has to do with other security issued in connection with a home mortgage. Current law applies nonmodifiability where the claim is secured "only" by a lien on the debtor's principal residence. Questions have arisen as to whether security incident to a mortgage (such as an assignment of rents) result in the loss of nonmodifiability. The proposal deals with these questions by requiring only that the claim be primarily secured by a homestead mortgage. This change may be overbroad. Debtors may give home mortgages as additional security in connection with a business loan—clearly not the kind of loan for which the special protection was found necessary—and the business lenders could argue (particularly if the business fails) that the home mortgage was their "primary" security.

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The remaining change made by this section involves the automatic stay. Some decisions have held that, in order to avoid violation of the automatic stay, a lender with a foreclosure pending at the time of a bankruptcy filing would have to dismiss the proceeding. Then, if the automatic stay were terminated, the lender would be required to serve all required notices and otherwise recommence the proceeding. The proposal would allow, instead, a simple continuance of the proceeding as of the time of the bankruptcy filing, so as to allow immediate recommencement in the event of termination of the stay.

ALTERNATIVE. Instead of providing for nonmodifiability whenever a homestead is the "primary" security for a loan, the needs of mortgage lenders could be addressed by a provision applying nonmodifiability to any loan secured only by a mortgage and by interests associated with the mortgage.

Subtitle C ("Adequate Protections for Secured Lenders")

141 ("Debts incurred to pay nondischargeable debt") (see H.R. 2500, 106).

THE CHANGES. Current 523(a)(14) provides that debts incurred to pay nondischargeable tax obligations are nondischargeable. This provision would expand 523(a)(14) to apply to all nondischargeable debt and would further provide that the debt to pay nondischargeable debt would have the same priority as the debt it was incurred to pay.

THE IMPACT. The impact of this proposal would be an arbitrary imposition of nondischargeability. The provision is not limited to debts incurred fraudulently, which are already nondischargeable under 523(a)(2). Thus, this proposal would apply to debts incurred in good faith, and would render them nondischargeable based simply on how the debtor chose to use the borrowed funds. If the debtor used borrowed funds to pay rent, and other funds to pay child support, the debtor would have no nondischargeable debt. But if the debtor used the same borrowed funds to pay child support, and the other funds to pay rent, the borrowed funds would be a nondischargeable debt, required to be paid as a priority.

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Moreover, the provision presents substantial tracing problems. Section 523(a)(14) has had little impact thus far, perhaps because of the difficulty in tracing the source of cash used to pay taxes. It would similarly be difficult to trace

the source of cash used by a debtor to pay nondischargeable obligations, such as child support, whenever these obligations were paid from an account into which the debtor deposited both borrowed funds and funds received from other sources.

142 ("Credit extensions on the eve of bankruptcy presumed nondischargeable") (see H.R. 2500, 107).

THE CHANGES. Current 523(a)(2)(C) provides that if a debtor borrows more than $1000 from a single creditor for items that are not needed for the support of the debtor or the debtor's dependents, or takes cash advances of more than $1000, within 60 days of the filing of a bankruptcy, the debt is presumed to have been obtained by fraud. In keeping with the consensus reflected in In re Anastas, 94 F.3d 1280, 1285 (9th Cir. 1996), this would mean that the debtor is presumed to have incurred the debt without intending to repay it. The proposed change would expand this presumption to all consumer debts incurred within 90 days preceding the bankruptcy. [Note: the proposed language continues to include the phrase "consumer debts owed to a single creditor." In view of the fact that there is no longer a minimum borrowing requirement for invoking the exception, this phrase serves no purpose and may be confusing—e.g., creating the impression that only one creditor could assert the presumption.]

THE IMPACT. The impact of the presumption is to require debtors to carry the burden of establishing, in a creditor complaint alleging fraud, that they did intend to repay each debt incurred by them within three months of the bankruptcy filing. The expanded presumption would have an impact far beyond the credit card matters to which the presumption now applies, applying, for example to medical debts, grocery bills, and rent obligations. The impact of this provision would be increased by 143, which makes debts arising from fraud nondischargeable in Chapter 13.

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ALTERNATIVES. The present law could be amended to make clear that the misconduct leading to nondischargeability is incurring debt with an intent not to repay the debt. With this understanding, other circumstances might be set out in which debt incurred shortly before bankruptcy is presumed to be nondischargeable: for example, debt incurred to finance casino gambling, or debt incurred in excess of some percentage of the debtor's ordinary expenses.

143 ("Fraudulent debts are nondischargeable in Chapter 13 cases") (see H.R. 2500, 104).

THE CHANGES. This section would limit the superdischarge available in Chapter 13 by excluding from that discharge debts incurred by fraud (as defined by 523(a)(2) of the Code); by fraud or defalcation while acting as a fiduciary, embezzlement, or larceny (as defined by 523(a)(4)); and intentional torts (as defined by 523(a)(6)). [Note: the rationale of this section would require that debts covered by 523(a)(3)(B) also be nondischargeable in Chapter 13. Subparagraph (a)(3)(B) governs debts nondischargeable under 523(a)(2), (4), and (6), as to which notice was not given to the creditor in time to file a timely complaint to determine dischargeability.]

THE IMPACT. This provision would increase the recovery of certain creditors after the completion of a Chapter 13 case. However, the provision would also largely eliminate the superdischarge of Chapter 13, thus removing a major incentive for filing Chapter 13 cases, and would increase the need for court hearings.

The largest number of nondischargeability complaints brought before bankruptcy courts in recent years has been on account of alleged fraud by debtors in the use of credit cards. The courts have struggled with the application of the fraud provisions of 523(a)(2) of the Code to credit card debt, but a consensus is emerging that the use of a credit card is fraudulent if the debtor had an actual intent not to repay the credit card charge at the time the card was used. See *In re Anastas*, 94 F.3d 1280, 1285 (9th Cir. 1996). This, in turn, presents a question of fact that can require a trial. Rather than incur the expense of such a trial, a debtor may, under current law, seek relief under Chapter 13, and, if the plan is successfully completed, the debtor will be discharged from the credit card debt regardless of the circumstances under which it was obtained. Under the proposal, the question of the debtor's intent (and the dischargeability of the debt) would remain in Chapter 13, thus providing no incentive for the debtor to choose that chapter, and presenting the courts with the potential for more hearings on the dischargeability of credit card debt. Similar incentives to file Chapter 13 exist when the debtor has engaged in conduct that might give rise to claims for breach of fiduciary duty or

intentional torts. All of these incentives to file Chapter 13 are removed by this provision. It can thus be expected to increase the incentives to file Chapter 7—discharging all other debts without payment—leaving only the questionable debt to be dealt with outside of bankruptcy.

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144 ("Applying the codebtor stay only when it protects the debtor") (see H.R. 2500, 118; S. 1301, 305).

THE CHANGES. Under present law, if a Chapter 13 debtor is liable with another party on a particular debt, the creditor is automatically stayed from taking action against the other party, but the creditor may obtain relief from this codebtor stay if the codebtor received the consideration for the claim. Section 144 of H.R. 3150 would change this situation by providing that the codebtor stay would never go into effect if the debtor did not receive the consideration, so that the creditor, in that circumstance, could take action against the codebtor or property not in the possession of the debtor. The section also provides for termination of the codebtor stay as to any rented property that the debtor's plan proposes to abandon or surrender.

THE IMPACT. Contrary to the title of this section of the proposed bill, the codebtor stay in Chapter 13 never protects the debtor. Actions against the debtor are stopped by the automatic stay invoked in all chapters of the Code. Rather, the codebtor stay allows the Chapter 13 debtors to pay, through the plan, debts for which they are primarily responsible, and protects codebtors who did not receive the benefit of the debt (that is, true accommodation parties) from collection actions. Under current law, if the creditor believes that the nondebtor obligor was the one who really obtained the benefit of the debt, the creditor may seek relief from the codebtor stay to allow action to be brought against the codebtor (and property owned by the codebtor). The proposed change states that the codebtor stay never goes into effect when the codebtor received the benefit of the transaction. When the debtor and another party jointly incur a liability (like a joint loan, or a cosigned loan), it may not be clear which of the parties received the benefit of the transaction. Current law protects true accommodation parties by requiring that the creditor seek court permission before acting against them on the belief that they were the ones receiving the benefit of the transaction. The change would allow creditors to take action without court permission, and require that debtors seek sanctions for violation of the stay if the debtor was the actual beneficiary. It is not clear which approach is most efficient. The issue is not a common one.

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There is no apparent reason why a surrender of leased property should eliminate the need for the codebtor stay. Where a nondebtor signed a personal property lease as an accommodation to the debtor, the debtor would—under current law—retain the right to pay whatever obligations arose from the lease in full through the plan, regardless of whether the debtor kept the leased property. In such a situation, the party who signed the lease as an accommodation should continue to be protected from collection actions while the debtor was making plan payments.

145 ("Credit extensions without a reasonable expectation of repayment made nondischargeable") (new)

THE CHANGES. Current law deals with misuse of credit cards as a type of fraud, and, accordingly, the courts have generally held that misuse of a credit card is only nondischargeable if the debtor did not intend to repay the charges made before filing bankruptcy. Thus, a debtor who uses a credit card foolishly, but in good faith, is able to obtain a discharge of the resulting debt. See *In re Anastas*, 94 F.3d 1280, 1285 (9th Cir. 1996) (applying this interpretation). Section 145 of H.R. 3150 would change this rule to provide that if the debtor used a credit card "without a reasonable expectation or ability to repay," the resulting debt is nondischargeable. In this way, the debtor's financial situation would be reviewed as of the time the credit card was used, and, if a reasonable person would have concluded that the debtor was unlikely to be able to repay the debt, the debt would be nondischargeable.

The section makes a second change not related to its title, dealing with false written statements about the debtor's financial condition. Current law makes such statements the basis for nondischargeability only when, among other things, the debtor intends to deceive the creditor. The proposal would change this standard of intent to one of

negligence, allowing a finding of nondischargeability if the debtor did not take reasonable steps to assure that the statement was accurate.

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THE IMPACT. This proposal would make a major change in dischargeability law. In general, debts have been held nondischargeable under the Bankruptcy Code in only two situations: (1) where the debt is one that must be repaid for the good of society, such as taxes and family support, and (2) where the debtor has engaged in intentional wrongful conduct. Negligence, except in situations involving fiduciary duties, has not been a ground for nondischargeability. This proposal would institute a negligence standard for fraud, both in the use of credit cards and in the completion of financial statements.

The change with respect to credit card debt is the most significant, because so many of the nondischargeability cases now before the courts involve this issue. The impact of the change is to render nondischargeable all use of credit cards beyond the reasonable means of the debtors to repay.

The impact of the proposed change is magnified by two of the other changes proposed by H.R. 3150: the presumption of nondischargeability that would be created by 142, and the extension of nondischargeability to Chapter 13, proposed by 143. The combined effect of these provisions is to render all use of credit cards within 90 days of bankruptcy nondischargeable, in both Chapter 7 and Chapter 13, unless the debtor can prove that there was a reasonable prospect for repaying the charges.

Subtitle E ("Adequate Protections for Lessors")

161 ("Giving debtors the ability to keep leased personal property by assumption") (see H.R. 2500, 116).

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THE CHANGES. This section would make two principal changes to the Bankruptcy Code. First, it would remove from the estate (i.e., abandon) all leased personal property as to which the lease is not assumed. In Chapter 7, this abandonment would occur when the lease is rejected by the trustee (which occurs automatically, under existing law, if the trustee does not assume the lease within 60 days of the filing of a voluntary case). [Note: the section states that "the leased property is no longer property of the estate and the stay under section 362(a) of this title is automatically terminated." This language is redundant, since 362(c)(1) already provides that the stay terminates as to property of the estate when the property is no longer property of the estate. By including the extra language terminating the stay, this provision might lead to confusion, for example, the erroneous belief that the stay was terminated as to personal actions against the debtor arising out of the lease.] In Chapter 13, the abandonment would occur if the lease was not assumed in the plan and the codebtor stay would also terminate on lease rejection.

The second effect of the section is to permit the equivalent of reaffirmations with respect to leased property through assumption of the leases, and to eliminate the automatic stay as it would apply to discussions regarding such assumptions. Under the procedure set out by the section, the debtor would have to initiate discussions regarding assumption of a lease through a written notification.

THE IMPACT. The provisions regarding abandonment of leased property make explicit the implication that leased property as to which the lease is rejected is no longer part of the bankruptcy estate.

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The provisions regarding assumption of leases by the debtor in Chapter 7 may require additional safeguards. Reaffirmations of debt have been a sensitive subject under the Bankruptcy Code, since they involve debtors repaying debts that otherwise would be discharged. To prevent overreaching by creditors in this regard, the Code presently contains a number of safeguards applicable to reaffirmation, including information that must be given to the debtor,

determinations by debtor's counsel that the reaffirmation is in the debtor's best interest, and court authorization of reaffirmations for unrepresented debtors. Unless similar protections were enacted in connection with assumed leases (with cure of past due indebtedness) creditor overreaching could be a similar problem.

162 ("Adequate protection of lessors and purchase money secured lenders") (see H.R. 2500, 212).

THE CHANGES. This section of the proposed bill would create a new provision in Chapter 13, requiring payments to secured creditors and lessors of personal property. These payments would be in the amounts and frequency specified by the applicable contract unless the debtor sought a court order reducing the amounts and frequency. However, the court would be required to order payments no less than monthly in an amount no less than the depreciation of the property involved. These payments would be required to continue until the creditor began receiving "actual payments" under the Chapter 13 plan.

The section would also clarify the right of creditors to retain possession of the debtor's property, if it was properly obtained before the bankruptcy was filed, until the creditor receives the first adequate protection payment required by the section.

Finally, the section requires that debtors in Chapter 13 must provide proof of insurance of leased property and collateral within 60 days of the filing of the bankruptcy.

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THE IMPACT. Secured creditors are entitled to seek adequate protection, pending plan confirmation, under existing law, and are entitled to relief from the automatic stay if adequate protection is not provided. This provision would give secured creditors a presumptive right to more than adequate protection payments, because the underlying contract (for example, a mortgage or an auto note or lease) generally provides for payments at a level greater than necessary to offset depreciation. The debtor would be required to present a motion to reduce the presumptive payments to the actual level of depreciation (if any). That will involve significant additional cost in most Chapter 13 cases.

Under existing law, it may be unclear whether a creditor in rightful possession of a debtor's property at the outset of a bankruptcy case must return the property in the absence of adequate protection. The proposal would make it clear that adequate protection is required.

The requirement for periodic proof of insurance is an unnecessary burden on debtors, since creditors are generally informed by insurers as to any lapse in coverage. Moreover, if the creditor does not receive this information, the creditor would have to take action to ascertain the status of the insurance within the first 60 days of the bankruptcy case. Proof of insurance by the debtor at the conclusion of the 60 day period would add no protection to the creditor.

163 ("Adequate Protection for Lessors") (new).

THE CHANGES. Despite its caption, this section deals with an exception to the automatic stay. Under current law, lessors of nonresidential real estate (for example, shopping center lessors) may proceed with eviction proceedings after the lessee files a bankruptcy case, without violating the automatic stay, if the lease has terminated by expiration of its stated term prior to a bankruptcy filing. Section 163 of H.R. 3150 would expand the exception to cover all rented real estate. Thus, landlords would be allowed to evict a Chapter 13 debtor from their apartments, without obtaining relief from the automatic stay, if the leases had terminated prior to the bankruptcy filing.

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THE IMPACT. There is no reason for the automatic stay to apply to an expired residential lease. A lease can only be assumed by a debtor in Chapter 13 if it is unexpired, pursuant to 365(a) and 1322(b)(7). However, a debtor and landlord may well be in dispute about whether a lease has expired. Many leases have automatic renewal terms, contingent on notice being given or the lease not being in default. If there is a dispute about lease expiration, then,

under current law, the landlord would be required to obtain relief from the automatic stay before going forward with an eviction proceeding in state court. See, e.g., *Robinson* v. *Chicago Housing Authority*, 54 F.3d 316 (7th Cir. 1995) (affirming an order granting relief from the stay to pursue eviction). Under the proposed change, the landlord, in the event of such a dispute, would be able to go forward with the eviction, requiring the Chapter 13 debtor—believing that the lease was still in effect—both to defend the eviction proceeding and to bring a proceeding in bankruptcy court to have the landlord found in violation of the automatic stay. If the debtor prevailed, fees and costs would be awarded, pursuant to 362(h), but the problem for the debtor is in obtaining the funds to pursue proceedings in both courts. Although this is not a situation that arises frequently, it may be preferable to continue to require that evictions in situations of residential leases be subject to the automatic stay.

On the other hand, the proposed exception could be applied in Chapter 7 cases without harm to the rights of the debtor, since Chapter 7 debtors have no right to assume defaulted leases.

ALTERNATIVE. The expanded exception could be applied in Chapter 7 cases only.

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Subtitle F ("Bankruptcy Relief Less Frequently Available for Repeat Filers")

171 ("Extended period between bankruptcy discharge") (see H.R. 2500, 121).

THE CHANGES. Current law allows a Chapter 7 discharge to be entered only once in six years. The proposal would change this to a 10 year interval. Current law imposes no limit on Chapter 13 discharges, although the discharge can only be entered at the completion of a plan, and most plans require a three to five year period to complete under current law. The proposal would require that a Chapter 13 discharge not be granted if the debtor received any bankruptcy discharge within the five-year period prior to filing the Chapter 13 case.

THE IMPACT. These proposals would render large numbers of debtors unable to obtain any bankruptcy relief for an extended period of time, and would substantially reduce the incentives for using Chapter 13.

It is entirely possible for individuals to require bankruptcy relief on more than one occasion with a span of a few years. Job loss, medical problems, and divorce can each cause financial difficulties that an individual cannot overcome. Under current law, the individual can obtain a Chapter 7 discharge to address these problems only once in six years, but could submit to a Chapter 13 repayment plan and obtain relief within the six year period. The availability of such a discharge is one of the major incentives for the use of Chapter 13. That possibility is removed under present law, leaving the individual with no means of requiring creditors to accept pro rata payment of the debtor's available funds. The result would be the "race to the courthouse" that bankruptcy was intended to avoid, with the more aggressive creditors getting the larger share of wage garnishments and judgment lien foreclosures. The incentive for creditors to cooperate with consumer counseling services in these situations would also be greatly reduced, since the debtor would not have the option of bankruptcy in the event of noncooperation, and other noncooperating creditors will have an advantage over those who did cooperate.

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ALTERNATIVE. The required period between Chapter 7 discharges could be extended without imposing limits on Chapter 13 discharges.

Subtitle G ("Exemptions")

181 ("Exemptions") (see H.R. 2500, 113).

THE CHANGES. This section impacts the perceived problem of debtors changing their residence in order to obtain more favorable homestead exemptions. Current law applies the homestead exemption law of the place where the

debtor's domicile was located for the largest part of the 180 days preceding the bankruptcy. Thus, a debtor could obtain a homestead exemption by establishing a domicile in a new state 91 days prior to filing a bankruptcy. The change would increase the 180 day period to 365 days, requiring that a debtor, seeking a homestead exemption in a new state, must establish a new domicile 183 days before filing bankruptcy.

THE IMPACT. This proposal will likely have very little impact. Only a few, wealthy debtors are likely to change state of domicile in order to obtain larger exemptions, and those debtors are likely to be able to wait for six months before filing bankruptcy.

ALTERNATIVES. The fundamental issue regarding exemptions is whether they should be more uniform, so that debtors do not receive significantly differing treatment in bankruptcy depending on their state of domicile. Greater uniformity would reduce the incentive for debtors to change domicile before filing bankruptcy petitions, and such a change in exemption law has been proposed by the National Bankruptcy Review Commission. Final Report at 117–44. H.R. 2500 proposes a new commission to study the question.

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Title II ("Business Bankruptcy Provisions")

Title III ("Municipal Bankruptcy Provisions")

These titles do not involve consumer bankruptcy issues and are therefore not treated in this analysis.

Title IV ("Bankruptcy Administration")

Subtitle A ("General Provisions")

401 ("Adequate preparation time for creditors before the first meeting of creditors in individual cases") (see H.R. 2500, 204).

THE CHANGES. This section would amend the Bankruptcy Code to provide that first meetings of creditors take place between 60 and 90 days after the filing of voluntary individual bankruptcy cases, unless the court orders an earlier meeting.

THE IMPACT. Under current law, set out in Fed.R.Bankr.P. 2003(a), the first meeting of creditors must take place between 20 and 40 days after case filing in voluntary Chapter 7 and 11 cases, and between 20 and 50 days in a Chapter 13 case. The proposal would delay these times by more than a month. This may allow greater creditor involvement in consumer bankruptcy cases, but it would have the drawback, particularly in Chapter 13 cases, of delaying payouts to creditors.

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402 ("Creditor representation at first meeting of creditors") (see H.R. 2500, 205; S. 1301, 308).

THE CHANGES. This provision would allow nonattorneys to represent creditors at creditor meetings.

THE IMPACT. This proposal would have the potential for increasing creditor involvement in any areas where appearances by nonattorneys are currently prohibited.

403 ("Filing proofs of claim") (see H.R. 2500, 209).

THE CHANGES. This section changes the law that currently requires the filing of a proof of claim in order for a creditor to share in the distribution of payments in Chapter 7 and 13 cases. Under this provision, a proof of claim

would be deemed filed as to all debts scheduled by the debtor as other than disputed, contingent, or unliquidated.

THE IMPACT. Frequently, consumer debtors have poor records of what they owe. Accordingly, the debtors often schedule debts that either are not owed, or are owed in smaller amounts than scheduled. The requirement of a proof of claim by the creditor assures that an actual debt is paid in an appropriate amount. Treating all scheduled debts as proofs of claim may result in overpayments of claims, or payment of claims that are not owing, reducing the payments to creditors with actual, accurate claims.

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The requirements for filing proofs of claims, as well as the results of untimely filing, were extensively treated in the 1994 Bankruptcy Reform Act. This provision would undo what has only recently become settled law.

404 ("Audit procedures") (see H.R. 2500, 202; S. 1301, 307).

THE CHANGES. This section of the proposed bill would establish a system for random audits of the accuracy and completeness of schedules and other information required to be provided by debtors in bankruptcy. The proposal would require that at least 2% of all cases be audited "in accordance with generally accepted auditing standards . . . by independent certified public accountants or independent licensed public accountants." The proposal requires the Attorney General to establish procedures for fully funding the audits, but does not specify a source of funding. The report of each audit is to be filed with the court, the Attorney General, and the United States Attorney, and if the audit report discloses any material misstatement of income, expenses, or assets, notice of the misstatement is required to be given to creditors and to the United States Attorney for possible criminal investigation. [Note: the sentence of the proposal dealing with material misstatements requires rewriting to correct syntactical errors.]

THE IMPACT. This proposal reflects a recommendation of the National Bankruptcy Review Commission (Final Report at 107–110), and would provide an incentive for debtors and their counsel to provide accurate and complete information. However, formal audits by licensed accountants would also generate substantial costs. With bankruptcy filings exceeding 1 million per annum, an audit cost of only $500 per case would impose an additional cost of at least $10 million per annum; at $1000 per case, a more likely figure given the poor record-keeping of many consumer debtors, the 1.4 million bankruptcies filed last year would generate an audit cost of $28 million. Since the proposal does not identify a source for funding the audits, the impact of the cost is uncertain. If the cost were treated as an administrative expense, creditors would pay for the audits in the form of reduced payments on their claims. A fairer way to pay for audits would be through the fees currently collected from debtors (at the time of filing) and creditors (seeking relief from the automatic stay), but to allow payment from current fees, the cost of the audits would have to be restrained.

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Additionally, the requirement that audit reports be filed will impose additional costs for document retention on clerk's offices, and, depending on the detail of the reports, involve unnecessary intrusions on the debtors' privacy.

ALTERNATIVES. In order to reduce costs, audits could be conducted by trained employees of the United States trustees, rather than by licensed accountants, according to regulations established by the Executive Office of the United States Trustee, rather than generally accepted auditing standards. With costs controlled, the source of funding for the audits can be specified as the existing fees collected in bankruptcy cases, without an increase in those fees.

405 ("Giving creditors fair notice in Chapter 7 and 13 cases") (see H.R. 2500, 206; S. 1301, 309).

THE CHANGES. The primary change made by this section is a requirement that creditors be given notice of a bankruptcy filing at their preferred addresses. Under current law, if a creditor actually receives notice of a bankruptcy case, it may be liable for sanctions for willful violation of the automatic stay if it thereafter takes action to enforce its rights against collateral or otherwise collect a debt owed by the debtor. This provision would eliminate sanctions for

violation of the stay (or failure to turn over property of the estate) in situations where notice of the bankruptcy was sent to an address of the creditor other than the last address it provided to the debtor for correspondence regarding the debtor's account. This elimination of liability would only apply if (1) the creditor had a designated person or department for receiving bankruptcy notices, (2) the creditor had a reasonable procedure for directing bankruptcy notices to that person or department, and (3) despite the reasonable procedures, the creditor's designated person or department did not receive the notice in time to prevent the collection activity from taking place.

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THE IMPACT. This proposal would eliminate sanctions for violation of the automatic stay in situations where notice of a bankruptcy was received by personnel of the creditor who were unable to prevent subsequent collection action. However, it would also greatly complicate litigation regarding violations of the automatic stay. If a creditor took collection action after the bankruptcy case was filed, there would be questions subject to litigation concerning (1) the last address specified by the creditor in a communication, (2) whether the creditor had reasonable procedures in place for directing the communication to a particular person or department, and (3) whether that person or department received the notice in time to prevent the collection activity from taking place. Most of the information relating to these matters would be exclusively in the possession of the creditor, making it difficult for debtor's counsel to determine whether an intentional violation of the automatic stay had occurred without substantial discovery. Lacking the resources to pursue such discovery, debtors might be unable or unwilling to pursue enforcement action.

406 ("Timely filing and confirmation of plans in Chapter 13") (see H.R. 2500, 114; S. 1301, 304).

THE CHANGES. This section would set a time limit for Chapter 13 debtors to file plans—30 days after the filing of the bankruptcy case. The section would also require that hearings on the confirmation of the plan take place within 45 days of the filing of the plan. In each situation, the court could order the deadline altered.

THE IMPACT. Under current law, Fed.R.Bankr.P. 3015(b), a plan is required to be filed either with a Chapter 13 petition or within 15 days thereafter, unless extended by the court for cause. The proposal would increase the time in which a debtor would be allowed to file a plan. This, in turn, would delay payments into the plan, which are required by 1326(a) of the Code to commence within 30 days after the plan is filed. There is no current time limit for the hearing on confirmation, but some courts have determined to delay confirmation until after the deadline for filing claims has passed. The proposed change would require that these courts enter orders extending the time for hearing if this practice were to be continued. This section conflicts with other provisions of H.R. 3150. See the discussion in connection with 409, below.

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ALTERNATIVES. In order to effectuate timely confirmation of Chapter 13 plans, the 15 day time limit for plan filing might be enacted as part of the Code itself, rather than being part of the bankruptcy rules.

407 ("Debtor to provide tax returns and other information") (see H.R. 2500, 210; S. 1301, 301).

THE CHANGES. This section would add several items to the information that individual Chapter 7 and 13 debtors are required to provide in connection with a bankruptcy case, unless ordered otherwise by the court. These items include (but are not limited to) the following: (1) copies of any federal tax returns, including schedules and attachments, filed by the debtor during three years prior to the bankruptcy case; (2) copies of any tax returns and schedules filed during the pendency of the case, either for current tax years, or for the three years preceding the filing; (3) any amendments of the returns set out above; (4) evidence of payments made by any employer of the debtor during the 60 days prior to the filing of the case; and (5) a certificate regarding the debtor's receipt of the proposed required notice regarding consumer counseling services. In addition, a Chapter 13 debtor would be required to file annually a statement of the debtor's income and expenditures in the preceding year and the debtor's monthly net income during that year, showing how calculated, disclosing the amount and sources of income, the identity of the persons responsible with the debtor for the support of any dependents, and any persons who contributed (and the amounts contributed) to

the debtor's household. Also, debtors would have the obligation to provide copies of their petition, schedules, statement of affairs, and any plan and plan amendments to any creditor on request of the creditor, and any copies of such filings made subsequent to the request. Tax returns would be filed with the United States trustee; the other information would be filed with the court. All of these filings, including the tax returns and amendments, would be available to any party in interest for inspection and copying.

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THE IMPACT. This section has the potential for making information available to trustees and creditors that may be significant in the administration of the debtor's case. However, Fed.R.Bankr.P. 2004 currently allows information regarding the debtor's financial condition—including tax returns—to be obtained, as required, with disclosure limited to the parties who need the information, and with the potential for court orders limiting further disclosure. The general disclosures required by the changes proposed here would impose two significant burdens not part of current law: (1) There would be a potentially difficult and expensive provision of information in every case, regardless of the need for the information. Since debtors in financial distress often fail to retain financial documentation, it is likely that they will not have ready access to their tax returns for the three years preceding the bankruptcy, or to their pay stubs for two months preceding bankruptcy. Similarly, during a bankruptcy, debtors are likely to have difficulty maintaining detailed records regarding their expenditures and sources of income. (2) The changes would involve a significant intrusion into the privacy of the debtors. Tax returns are not public documents, and are ordinarily disclosed in litigation only when they are particularly relevant to a dispute, and only to the parties with a need to review them. This provision would require debtors to make several years of their tax returns available for review by any creditor, and the creditors would be free to make whatever use they wished of the information contained in the returns, including compiling and disseminating it. Both the difficulty and cost of assembling the required information and the intrusion on privacy would act as substantial barriers to good faith bankruptcy filings.

The requirement that debtors provide copies of petitions, schedules and plans to all creditors on request may encourage routine requests for such documents by creditors who do not require these documents for their participation in the bankruptcy case (current law requires notice to creditors of the essential events in the case), imposing additional expense on debtors and their counsel.

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The provision that the required information need not be supplied if the court orders to the contrary creates the potential for substantial variations in practice from court to court. Some judges may determine that certain of the information (or all of it) is not required unless requested by a creditor with cause; other judges may routinely deny any request by debtors to limit the information. No standards are supplied.

Finally, the need to file all of the additional documents in each consumer case would impose a substantial additional cost on the clerks' office and the offices of the United States trustees.

408 ("Dismissal for failure to file schedules timely or provide required information") (see H.R. 2500, 211; S. 1301, 312).

THE CHANGES. This section creates a new ground for dismissal of Chapter 7 and 11 cases—failure to provide the information required by 407. Failure to file initial documents (including past tax returns and pay stubs) results in mandatory, automatic dismissal on the 46th day after filing, subject only to a timely request by the debtor for an extension of up to 15 days. The court is required to enter an order confirming the dismissal if requested by any party. Failure to file (or supply to creditors on their request) any subsequently required documents is also subject to mandatory dismissal, upon request of any party in interest. The deadline for compliance with a creditor request is to be set by the court within 10 days of the request, and may not exceed 30 days.

THE IMPACT. The difficulty of complying with the proposed initial disclosures (of tax returns and pay stubs) is noted in the commentary on 407, above. Section 408 would impose automatic dismissal as a penalty for failure to

comply with these disclosure requirements, without providing notice to the debtor of any deficiency in the filing. Although the debtor is given an opportunity to seek an additional 15 days to comply, no further extensions are authorized. Given that it may take more than 60 days to obtain copies of tax returns from the Internal Revenue Service, these provisions may result in unavoidable dismissal of cases filed in good faith. In connection with enforcing the requirements for postpetition copies and tax information, the court is also given no discretion. It must order the information produced and dismiss the case if the order is not complied with. These provisions would discourage good faith filings at the outset, and may result in dismissal of cases that are filed and prosecuted in good faith.

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Rather than making debtors subject to such dismissal, some courts may generally order that the documents need not be filed, but, as noted above, in the discussion of 407, no standards are provided for orders of nonproduction, and practice among courts can be expected to vary widely.

ALTERNATIVE. The failure of a debtor to provide information ordered by a court to be produced to a creditor in connection with an examination pursuant to Fed.R.Bankr.P. 2004 could be specified as a ground for dismissal of both Chapter 7 and Chapter 13 cases.

409 ("Adequate time to prepare for hearing on confirmation of the plan") (see H.R. 2500, 213; S. 1301, 313).

THE CHANGES. This section provides that the hearing on confirmation of a Chapter 13 plan must take place no sooner than 20 days and no later than 45 days after the first meeting of creditors.

THE IMPACT. H.R. 3150 is internally inconsistent in setting the time for the hearing on confirmation of a Chapter 13 plan. Section 406 requires that the hearing on confirmation take place within 45 days of plan filing, which may be no later than 30 days after the filing of the case. Thus, 406 requires that the confirmation hearing take place *no later than 75 days after the bankruptcy filing*. However, under Section 401, the earliest that the creditor's meeting can take place is the 60th day after case filing, and 409 requires that the confirmation hearing take place no earlier than 20 days thereafter, or *no earlier than the 80th day after filing*. It is impossible to comply with both sets of provisions.

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Present law, which requires prompt filing of plans (within 15 days of the filing of a Chapter 13 case), and prompt creditor meetings (between 20 and 50 days after case filing), with no deadline for the confirmation hearing, allows (1) the creditor meeting to take place after the plan is filed, and (2) the creditor meeting to take place prior to confirmation. There does not appear to be any need to change these time frames. The different times provided for by the proposed bill would delay plan confirmation in many cases, without assuring more time for creditor review of the plan.

ALTERNATIVE. If a change is to made in the time frames of current law, the various provisions now included in H.R. 3150 must be harmonized.

410 ("Chapter 13 plans to have a 5-year duration in certain cases") (see H.R. 2500, 117).

THE CHANGES. This section would increase the term of Chapter 13 plans from the present range of three to five years to a new range of five to seven years, for all debtors with total monthly income equal to at least 75% of the national median for their household size. The proposal would retain the three-to-five year range for those earning less than 75% of the applicable median. In each situation, plans lasting longer than the minimum plan term would require court approval. These provisions should be read in conjunction with 102 of the proposed bill, discussed above, which requires that all net income of the debtors be paid to general unsecured creditors for the minimum plan term.

The section also amends 1329 of the Code, which governs modified plans. Although an original plan is allowed, with court approval, to have a duration two years beyond the minimum term, the amendment would prohibit this

extension for modified plans.

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THE IMPACT. Consistent with 102 of H.R. 3150, this section would have the effect of lengthening the minimum Chapter 13 plan term from 3 to 5 years for most Chapter 13 debtors. This increase in minimum plan length may result in increased payments to creditors, but only if the plans are completed. Increased plan length may discourage use of Chapter 13 by debtors who have the choice of Chapter 7, and may decrease successful plan completion by those who do choose Chapter 13.

Extending plans beyond the minimum term is sometimes in the debtor's interest—in order to cure large mortgage arrearages or retire nondischargeable debt. There is no apparent reason why this extension should be prohibited in modified plans.

411 ("Sense of the Congress regarding expansion of Rule 9011 of the Federal Rules of Bankruptcy Procedure") (new).

THE CHANGES. Fed.R.Bankr.P. 9011 is the bankruptcy analog to Rule 11 of the Federal Rules of Civil Procedure. It requires the signature of the attorney (for a represented party) or of the party (if unrepresented) on documents filed with the court, and provides that this signature constitutes a certificate that the document is, among other things, well grounded in fact—based on the signer's knowledge, information, and belief, formed after reasonable inquiry. Currently, Rule 9011 does not apply to schedules, apparently with the understanding that debtor's attorneys are not economically able to independently verify the accuracy of the information supplied by their clients. This section suggests that the Rule be modified to apply to all filings, specifically including schedules.

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THE IMPACT. Requiring independent verification by debtor's attorneys of all of the schedule information required of their clients would delay bankruptcy filings and increase the cost of legal services, thus discouraging good faith filings. In light of the auditing requirement proposed both by this bill and by the National Bankruptcy Review Commission, it is questionable that attorney verification of schedules is needed to assure accuracy.

412 ("Jurisdiction of Courts of Appeals") (new)

THE CHANGES. Under present law, appeals of decisions of bankruptcy courts are heard by the district courts or by Bankruptcy Appellate Panels, composed of bankruptcy judges. This section would grant jurisdiction over such appeals to the Circuit Courts of Appeals.

THE IMPACT. The current system of appeals generates appellate decisions that are largely without binding precedential impact. Decisions of the Courts of Appeals would be binding on all courts within the circuit, promoting intercircuit uniformity.

Subtitle B ("Data Provisions")

441 ("Improved bankruptcy statistics") (see H.R. 2500, 201: S. 1301, 306).

THE CHANGES. This section would require the Director of the Executive Office for United States Trustees to compile bankruptcy data in specified categories and require the Administrative Office of the United States Courts to specify the form of the data and make it public.

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THE IMPACT. Although this provision would be costly to implement, it has the potential for making useful information available to those interested in the functioning of the bankruptcy system. The National Bankruptcy Review

Commission (Final Report at 921–43) recommended that a similar program of data collection and reporting be implemented. One potential problem in the proposed legislation is in its specification of matters for data collection and reporting. The Review Commission suggested a pilot program to develop effective programs, and this might be preferable to establishing categories for data collection by legislation. As an example of the problem with legislative specification, the proposal includes a requirement that data be collected and reported as to "the number of [Chapter 13] cases in which a final order was entered determining the value of property securing a claim less than the claim." Such a report would likely yield little useful information, since in many situations of the cramdown of secured claims the parties negotiate an appropriate bifurcation, with no court order entered.

ALTERNATIVES. It may be preferable to implement the Review Commission's recommendation of a pilot program to determine effective categories and methods of data collection and reporting.

442 ("Bankruptcy data") (see H.R. 2500, 203)

THE CHANGES. This proposal would require the Attorney General to issue regulations for uniform reporting of bankruptcy cases on standard forms, designed to facilitate both physical and electronic access to the information contained in the reports. Detailed contents of the reports are specified.

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THE IMPACT. A consistent reporting system would provide many benefits, and has been recommended by the National Bankruptcy Review Commission as part of a national bankruptcy filing system (Final Report at 105–07). As with the prior provision of the proposed bill, there may be some difficulty with the details it sets out.

ALTERNATIVES. It may be preferable to allow the details of any reporting system to be developed by the office administering the system.

443 ("Sense of the Congress regarding availability of bankruptcy data") (see H.R. 2500, 203).

THE CHANGES. This proposal effectively recommends that Congress establish a national bankruptcy filing system.

THE IMPACT. A nationwide reporting system would provide many benefits, and has been recommended by the National Bankruptcy Review Commission (Final Report at 105–07).

Title V ("Tax Provisions")

Most of the sections of Title V do not involve consumer bankruptcy issues and are therefore not treated in this analysis.

502 ("Enforcement of child and spousal support") (new)

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THE CHANGES. This section adds additional language to a provision of Section 522(c) that excepts certain tax and family support obligations from the general rule that exempt property is not liable for debts. See *In re Davis*, 105 F.3d 1017, 1022 (5th Cir.1997) (allowing enforcement of child support against property exempt under state law).

THE IMPACT. Although the proposed language is apparently intended to clarify the meaning of the statutory provision, it does so by creating an exception to the exception already in the statute, and may therefore engender additional confusion.

503 ("Effective notice to government") (new)

THE CHANGES. This section specifies that all notices from a debtor to a governmental agency (as well as the original scheduling of the agency as a creditor) must contain detailed information regarding the nature of the agency and its claim. For example, a real estate tax claim is required to be identified by real estate parcel number. The clerk of court is required to maintain a register of "safe harbor" mailing addresses that may be used by debtors. The Advisory Committee on Bankruptcy Rules of the Judicial Conference is required to propose "enhanced rules" for providing notice to governmental agencies, incorporating the provisions earlier set out in the section. Notices not in compliance with the proposed requirements would have not effect unless, among other things, the debtor showed either that notice was sent to the safe harbor address, or both that no safe harbor address had been specified and that there was actual notice to a responsible officer of the appropriate agency. If notice of the commence of the case was not given in compliance with the requirements of the section, governmental violations of the automatic stay and turnover provisions of the Code would not result in any sanction

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THE IMPACT. The provision would provide surer notice to governmental agencies. Some of the detail required, however, may unnecessarily increase the cost of case filing, and litigation can be anticipated on issues of whether notices were in compliance with the requirements. See the discussion in connection with 405, above.

508 ("Chapter 13 discharge of fraudulent and other taxes") (new)

THE CHANGES. This section would make the tax obligations that are defined by 523(a)(1) of the Code nondischargeable in Chapter 13 cases as well as in Chapter 7 cases.

THE IMPACT. Together with 143, this section of H.R. 3150 has the effect of largely eliminating the superdischarge of Chapter 13. See the discussion of this issue in connection with 143, above.

514 ("Tardily filed priority tax claims") (new)

THE CHANGES. The Bankruptcy Code was amended in 1994 to provide that tardily filed tax claims are entitled to priority in Chapter 7 cases until the time that the trustee commences distribution. This section would provide, instead, that tardily filed tax claims are entitled to priority until the court approves the trustee's final report and accounting.

THE IMPACT. This section would create very difficult problems of administration for trustees. The section would apply in situations where the trustee had already distributed the assets of a Chapter 7 case, but before the trustee's final report had been approved, and, in these situations, provide that a late-filed priority tax claim retains its priority. As a result, the trustee would have to pay the claim ahead of other claims of lower priority, even though distributions were already made on account of those claims. Accordingly, the trustee would have to attempt recovery of the previously distributed funds, generating substantial additional administrative expense and consequently reducing the overall distribution. There is no apparent justification for this result.

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517 ("Requirement to file tax returns to confirm Chapter 13 plans") (new).

THE CHANGES. This section would impose on Chapter 13 debtors the obligation to file, as a condition for confirmation, all prepetition tax returns. Deadlines are specified for the filing of the returns (at least 120 days from the filing of the bankruptcy case), and failure to comply is specified as a ground for conversion or dismissal of the case. The taxing body is given 60 days after the filing of a return to submit a timely claim for the tax involved in the return. Finally, it is suggested that the Federal Rules of Bankruptcy Procedure be amended to allow objections to confirmation to be made by a taxing body "on or before 60 days after" the debtor files all of the required tax returns.

THE IMPACT. These provisions are largely reasonable, and will assist the debtor and the taxing bodies in

resolving past due tax obligations. However, the suggested change in the bankruptcy rules further complicates the already very confused issue of when a confirmation hearing is supposed to take place under the provisions of H.R. 3150. See the discussion in connection with 409, above. In order to allow the suggested objection based on the filing of a tax return 120 days after the bankruptcy filing, confirmation hearings would have to be scheduled six months after the filing of the case.

Title VI ("Miscellaneous")

This title does not involve consumer bankruptcy issues and are therefore not treated in this analysis.

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Mr. **GEKAS.** We thank the Judge, Judge Wedoff, I have to repeat. Prof. Morris is next.

STATEMENT OF JEFFREY W. MORRIS, PROFESSOR OF LAW, UNIVERSITY OF DAYTON SCHOOL OF LAW, REPRESENTING THE NATIONAL BANKRUPTCY CONFERENCE

Mr. **MORRIS.** Thank you, Mr. Chairman. My name is Jeff Morris. I am a law professor at the University of Dayton and I am here today on behalf of the National Bankruptcy Conference. The Conference is an association of about 70 or so judges, lawyers, and academics dedicated to the improvement of the bankruptcy laws. And we have long been active in that process and hopefully positively assisting the Congress along the way. We pledge our assistance in that continuing vein.

One of the primary focuses of the bills before the committee is the notion of needs-based bankruptcy. The position of the National Bankruptcy Conference is that that is not the solution that ought to be drawn upon. The problem that's suggested is that there are some bad faith filers; there are some people taking advantage of the system inappropriately.

A mechanical test that would try to ferret those people out is unlikely to catch the people who are intentional wrongdoers. By their very nature, they will adjust their behavior to avoid the parameters of any of these kinds of rules. Instead, what you catch are people who are the unintended recipients of the rule who are not as able and flexible or sophisticated to respond to these different provisions, tending to be people on the lower end of the spectrum.

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Even if technically they may fall under some of the provisions below the income limits, there are a number of other provisions in the bills that will require them to pay higher costs to obtain necessary bankruptcy relief. There are requirements for tax return filings; there are requirements for heightened degrees of information that many of the lower-income debtors would not have the slightest idea about.

And their lawyers now are put in the position of, in a sense, guaranteeing the accuracy of those items, a position that the creditor's lawyer tends not to be in on the other side, although the creditors tend to have much more available information on these issues.

The point is that we are attempting to create some barriers to entry to the system that may go beyond simply the access to chapter 7 via the means test. There are other provisions in the bills that can increase the cost to needy debtors for obtaining bankruptcy relief.

One of the ways in which the bills, H.R. 2500 and H.R. 3150, address the issue of trying to protect against wrongdoing is by instituting an audit process. Actually, the National Bankruptcy Conference agrees that some auditing of these filings is appropriate, but I think the method chosen here is misdirected.

First of all, it simply directs audits in one of every 50 cases. So, in the neighborhood of 25,000 audits have to be conducted by certified public accountants at some cost that's not clear how it is paid.

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Secondly, audits are especially effective when they're targeted, when there is something that suggests that something is a little bit amiss and we need to look more carefully at that. And so I think that the appropriate solution would be to direct some study into the process of auditing to see what the best way to accomplish getting that information is, getting the right people focused upon to make sure that they are not taking inappropriate advantage.

There are some other provisions in the bills that I think also ought to be carefully thought about. With respect to some of the increases in or the expansions of categories of nondischargeability, I think the underlying assumption is that debtors are acting in an inappropriate fashion and need to be reined in.

But the way the bill is written doesn't direct it toward those people. Once again, it's a blanket approach and the truly wrongdoing debtor simply works to get itself past the deadlines established in the bill, and the people who are less sophisticated get caught up in this big net.

And the unintended consequence of that may be, in fact, not necessarily fewer bankruptcies, but in some instances, more bankruptcies. The irony to me is that to the extent that you have greater amounts of nondischargeable debt, you in some ways have an incentive to file bankruptcy to get rid of the dischargeable debt so that you can focus all of your income on the nondischargeable debt.

In fact, the whole purpose of having a debt declared nondischargeable, is to get ahead of the other creditors. Who are those other creditors? Well, they've already been identified in some instances as alimony and support claimants, but they likewise hold nondischargeable debts. There are other involuntary creditors such as tort victims, and the medical services provider whose claims are discharged; but the credit card debt where the credit card company has the ability to voluntarily agree with the debtor on these relationships may have their debt accepted from the discharge. So there may be an unintended consequence there.

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Finally, with respect to valuation, there are provisions in the bill that limit or that require valuation for personal property purchased within 180 days of the filing to be valued at the full purchase price. There are a number of unusual ironies that come from that, including the fact that an automobile lender could have a debtor buy a vehicle, drive it around for 5 months, never pay a dime on it, file a bankruptcy and say here's your car back, I owe you nothing. The creditor has no right to an unsecured claim in this case, either.

I'm not sure that that was intended by the provision, but my point is only that those are the kinds of things that can follow from an effort to address problems and address them quickly and efficiently, but sometimes unintended consequences can follow.

And I'm available for questions. Thank you.

[The prepared statement of Mr. Morris follows:]

PREPARED STATEMENT OF PROF. JEFFREY W. MORRIS, PROFESSOR OF LAW, UNIVERSITY OF DAYTON SCHOOL OF LAW, REPRESENTING THE NATIONAL BANKRUPTCY CONFERENCE

Good Morning. Thank you for this opportunity to appear before the Subcommittee on behalf of the National Bankruptcy Conference(see footnote 9). The NBC has been engaged in a thorough and intensive study of the bankruptcy laws through the Code Review Project which began nearly 10 years ago. We have recently issued a paper setting out our proposals for consumer bankruptcy reform, and a copy of that Report is appended to this statement. As the Report indicates, there are some issues where we believe change in the bankruptcy laws is appropriate, and other matters that we believe are best left as they are under the current system. Moreover, in some instances where the NBC supports the

concept behind the changes proposed in H.R. 3150, we may have suggestions as to the drafting of those provisions in a manner that we believe is more consistent with appropriate fundamental bankruptcy policy. Also attached to this testimony is a proposed Bill which is submitted for your review. We believe that the provisions included in that Bill will improve the consumer bankruptcy system for all participants.

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The last several years have provided the impetus for the most extensive dialogue on consumer bankruptcy issues in our history. The work of the National Bankruptcy Review Commission focused to a large extent on consumer bankruptcy issues and generated extensive debate on those topics. Many groups, including the NBC, offered views to the Commission on a myriad of issues. At the same time, the number of bankruptcy filings continued its dramatic increase to the point where approximately 1.4 million bankruptcy cases were filed in 1997. These developments make it especially appropriate that the Congress address consumer bankruptcy review at this time. Nonetheless, the NBC urges that Congress be cautious in its efforts to strike the appropriate balance between the interests of creditors and debtors under the bankruptcy laws. When the earlier Bankruptcy Commission issued its Report to Congress in 1973, it took another five years before the Bankruptcy Reform Act of 1978 was enacted. Moreover, the Commission at that time offered to the Congress complete bankruptcy statute on which to base the final legislation. The Commission's Report issued this past October has no comparable comprehensive statutory solution. Instead, the Report offers direction as to policy choices without dictating the statutory language necessary to put those policy choices into law. Translating those policy choices into legislation is a difficult task, and the NBC is grateful to Congressman Gekas and others, including Congressman Nadler, who have authored bills to accomplish reform of the bankruptcy laws. Yet, the complexity of the issues presented suggests that a cautious approach to bankruptcy reform is particularly appropriate.

Perhaps the most fundamental reform offered by H.R. 3150 is the institution of means-testing for Chapter 7 bankruptcy eligibility. The NBC opposes the Means-testing proposals in both H.R. 3150 and H.R. 2500. We believe that the bankruptcy system can be improved by better addressing abuses that arise, but there is no need to enact comprehensive restrictions on Chapter 7 eligibility. The means-testing proposals would create an enormously expensive obstacle to relief for many debtors who present no significant risk of abuse in their bankruptcy filings. Nevertheless, the system proposed would require unnecessary audits of a substantial number of bankruptcy filings with no benefit to the bankruptcy system. These costs will have to be borne either by creditors through reduced distributions in cases, or by debtors who are already hard pressed to raise sufficient funds to pay the filing and attorney fees to obtain the relief. It is more likely that needy debtors will be foreclosed from obtaining bankruptcy relief and removed from their homes via foreclosures if the strict means-testing proposals now pending are adopted.

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The consumer credit industry has sought reforms of this nature for over 60 years. The real purpose for these proposals is not simply to prevent wrongdoers from obtaining improper relief, but instead to discourage a large number of debtors from seeking the relief they need. Another consequence of this is perhaps less immediately apparent but in many ways more important. The Bankruptcy Code, and the bankruptcy laws of this country in every enactment, allocate relief from debts in very specific ways. Some claims are excluded from a debtor's discharge to prevent wrongdoers from benefiting from their improper actions. Other claims are excepted because of the nature of the claims themselves. It has always been the policy to protect alimony and support claims in recognition of the fundamental obligation of debtors to provide that support. Indeed, Congress has recently has made alimony and support claims not merely nondischargeable, but also priority claims. Restricting access to Chapter 7 through means-testing can actually work to reverse those carefully considered distributional decisions. To the extent that debtors are excluded from Chapter 7, they are left to the vagaries of state collection laws. Well-financed creditors are much more able to use that system to collect their debts than are the children and former spouse of a debtor. Since debtors have only so much money, every dollar that is collected by a credit card company effectively comes out of the pocket of the debtor's children or other similar creditor who Congress has decided is a more worthy creditor than others. Indeed, many debtors may revert to an "underground" economy rather than succumb to the continual collection efforts that place a strangle hold on the debtor's paycheck. To the extent that these debtors go underground, they are out of the tax system, cannot plan for their retirement years, and place their families in significant and continuing financial peril.

The bankruptcy system must resolve a problem similar to that presented when an athletic team has a number of thirsty players but a single bucket of cool water. Allowing the first persons who drink from the bucket to continue drinking until their thirst is quenched can have devastating consequences for those at the end of the line. We are especially cautious about allowing the biggest and strongest "player" to drink first from the bucket. We recognize that other "players" may have more compelling reasons to be the first to drink from the bucket. And then, once we have taken care of those special needs, we generally propose a share and share alike system for the remaining amount of water. The bankruptcy system operates in exactly this fashion. To the extent that we force debtors out of the system, the stronger "players" such as the consumer credit industry will find that the rules in state courts much more amenable to them. The more vulnerable "players", however, will have nowhere to go to quench their thirst.

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This is not to say that the bankruptcy system is abuse-free. Anytime, significant numbers of people undertake a particular activity, there will be some who abuse that system. We believe that current 707 of the Bankruptcy Code is preferable to the bright-line tests that follow from a means-test eligibility system. By definition, Abusers of any system act intentionally. They identify the benefit they seek and adjust their behavior to obtain that goal. If the goal is the Chapter 7 relief, then abusers will focus on the mechanical restrictions to access and will "adjust" their behavior to meet those standards. Thus, the very people such a system seeks to identify and bar from bankruptcy relief will still frequently slip through the system. The persons who are caught by the system will more likely be those who are ignorant of the restrictions and who are not affirmatively seeking to circumvent those limits. This may translate into more bankruptcy relief available to debtors of higher income with greater access to legal assistant than lower and middle income debtors. Instead, the NBC believes that an appropriately structured auditing system could operate to reduce the instances of fraud and abuse. Targeting audits to cases that give some indication of potential impropriety represents a much more effective use of limited funds. It also allows the system to make use of the collective wisdom and experience of the panel trustees who see thousands of cases annually as well as the Office of the United States Trustee.

There are two areas where the NBC has concern about excessive or inappropriate benefit for debtors through bankruptcy. The first is the unlimited exemptions available to some debtors that create perverse incentives for those persons to obtain bankruptcy relief when it is unnecessary. The second is the problem presented by repetitive bankruptcy filings that are made not for the purpose of obtaining bankruptcy relief but rather for the purpose of obtaining the benefit of the automatic stay without truly submitting to the bankruptcy system. Similarly, debtors who engage in schemes to create fractional interests in property so as to permit consecutive bankruptcy filings to frustrate the proper collection of secured claims should be identified and barred from obtaining this relief. Once again, however, Congress should be careful in drafting the language necessary to accomplish these important goals to be sure that we are not casting such a wide net that debtors with legitimate needs are barred from obtaining necessary relief. Here again, it is important to recall that it is not just debtors who can be harmed by a denial of access to bankruptcy courts. Creditors who are less powerful but more worthy will not obtain the benefit of the special status that Congress has bestowed upon them if collections are pursued in the state court systems.

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Several other provisions in H.R.3150 would have an impact on the system much greater than might first appear. For example, Subtitle D of the Bill amends 523(a)(2) in subtle but significant ways. The proposals would expand the categories of nondischargeable debt to render credit card issuers preferred status as against other creditors. Granting this special status increases the potential for harm from creditor overreaching through dischargeability actions used simply as leverage to obtain reaffirmation agreements that may or may not otherwise comply with 524 of the Bankruptcy Code. Moreover, expanding this category of nondischargeable debts ultimately injures other creditors whose claims are discharged. For example, debtors with uninsured medical expenses and debts from the neglect operation of a motor vehicle are encouraged to discharge those obligations so that more of their income can be channeled to credit card obligations. Ironically, the tort victim and medical service providers are essentially involuntarily creditors in that they do not encourage the debtor to incur those obligations. Credit card lenders on the

other hand, spend millions annually to encourage debtors to enter into transactions. Yet, these provisions would protect the "voluntary" credit card lender to the detriment of the involuntary creditors like the local hospital emergency room or the victim of a debtor's neglect operation of a motor vehicle. Certainly, the system should not distribute its protections in that manner.

Also absent from H.R. 3150 is any recognition of a need for balance in the system to protect to against creditor overreaching. There is widespread evidence to support a conclusion that some creditors systematically ignore the requirements of the Bankruptcy Code and Rules that require accurate and full disclosure of claims as well as prohibit reaffirmation agreements except according to the requirements of 524(c) and (d) of the Bankruptcy Code. This lack of balance suggests that there may not be a full appreciation of the consequences of adoption of specific proposals. In bankruptcy, there is only so much to go around. To the extent that the flow of a debtor's income goes to one creditor, it comes at the expense of another creditor. Furthermore, to the extent that the system provides excessive protection for a particular kind of creditor, it runs the risk of undermining fundamental bankruptcy policy. Bankruptcy is by its nature a collective proceeding and among its goals is the provision for an equitable distribution of the available assets. While many of the proposals would limit or diminish a debtor's fresh start, it is important to note that they would also disrupt the distributional scheme that has generally been in place since the enactment of the Bankruptcy Act of 1898.

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In addition to the effective restructuring of creditor distributions, expanding the categories of nondischargeability (particularly for credit card debt) could have effects contrary to the stated purpose of the legislation. Making more debt nondischargeable would encourage even riskier lending than already takes place. The United States is awash in plastic. The *Wall Street Journal* has noted on many occasions the expansion of credit card indebtedness across the full range of consumers in this country. The credit card industry laments the increase in bankruptcy filings, yet it concurrently touts its own underwriting standards and its "low" default rates. Those Uunderwriting standards" are not disclosed, but it is clear that bankruptcy filings have increased dramatically. It is likewise clear that outstanding consumer debt has increased right along side the bankruptcy filing rates. Encouraging additional risky lending would not seem to be consistent with an effort to reduce bankruptcy filings.

Another item on which there is widespread agreement, if not consensus, is that the level of legal representation for consumer debtors is extremely limited. Whether one attributes this to the limited amount of fees that can be earned per case by a debtor's attorney, or to a general failing on the part of the legal profession, the result is the same for consumer debtors. They are often under represented. Creating a system that would increase the costs to them is only likely to diminish the limited representation they can obtain at this time. The careful, thoughtful, professional, and ethical debtors' attorneys will simply be priced out of the market of debtor representation if all of the burdens of system oversight fall on them. Leaving these debtors at the hands of professional collectors will simply encourage further risky lending because it will increase the prospects for recovering, at least something from debtors who have no real prospect of paying all their debts in any reasonable amount of time.

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In closing, the National Bankruptcy Conference reiterates our opposition to H.R. 3150 and 2500 which would interject means-testing as a eligibility requirement for Chapter 7 relief. While the bankruptcy system is not perfect, the drastic changes proposed to overturn 100 years of bankruptcy law and policy will do more harm than good. We believe a more cautious approach to resolving these problems will lead to effective reform consistent with the interests of all participants in the bankruptcy process.

Professor Jeffrey W. Morris has served on the faculty at the University of Dayton School of Law for 17 years. He is also of counsel for the law firm of Porter, Wright, Morris & Arthur. He has authored three books on bankruptcy law as well as numerous articles on bankruptcy and commercial law topics. He is a frequent speaker throughout the country on these matters. He is a member of the National Bankruptcy Conference and currently serves also as its Secretary. He was inducted as a fellow of the American College of Bankruptcy in 1997.

Neither Professor Morris nor the National Bankruptcy Conference have received any federal grant, contract or subcontract in the current or preceding two fiscal years. Professor Morris' testimony is offered on behalf of the National Bankruptcy Conference, and the positions stated here should not be attributed either to the University of Dayton or Porter, Wright, Morris & Arthur.

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See, e.g., In re Wolf Financial Group, Inc., 1994 WL 913278 (Bankr. S.D.N.Y. 1994); *Bilzerian* v. *SEC*, 146 B.R. 871 (M.D. Fla. 1992); *SEC* v. *Sterns*, Fed. Sec. L. Rep. 96,200 [CCH 1991 Transfer Binder] (C.D. Cal. 1991); *SEC* v. *Kane*, 212 B.R. 697 (Bankr. D. Mass. 1997).

(Footnote 2 return)
See Taylor v. *Freeland & Kronz*, 503 U.S. 639 (1992) (exemptions lacking any colorable basis are immune from attack if not timely objected to by trustee or creditors).

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See SEC v. *Bilzerian (In re Bilzerian)*, 1995 WL 934184 (M.D. Fla. 1995) (reversing bankruptcy court dismissal of Commission's adversary complaint against criminally convicted securities violator for lack of standing); *SEC* v. *Bilzerian (In re Bilzerian)*, 1996 WL 885850 (M.D. Fla. 1996) (reversing bankruptcy court grant of summary judgment against Commission and ordering summary judgment entered on Commission's adversary complaint against same debtor); *SEC* v. *Cross (In re Cross)*, 1998 Bankr. LEXIS 214 (9th Cir. BAP, 2/23/98) (reversing bankruptcy court dismissal for lack of standing of Commission adversary complaint based on securities fraud judgment against debtor). We are continuing to have to litigate such issues, circuit by circuit.

(Footnote 4 return)
See Yellow Cab Cooperative Ass'n v. *Metro Taxi, Inc. (In re Yellow Cab Cooperative Ass'n)*, 132 F.3d 591 (10th Cir. 1997).

(Footnote 5 return)
See Younger v. *Harris*, 401 U.S. 37 (1971); *Huffman* v. *Pursue*, 420 U.S. 592 (1972); *FTC* v. *Standard Oil of California*, 449 U.S. 232 (1980).

(Footnote 6 return)
See In re Hunt, 93 B.R. 484 (Bankr. N.D. Tex. 1988) (enjoining CFTC action against commodities manipulator). The Commission currently is subject to a bankruptcy court injunction requiring it to extend confidentiality protections to an investigatory subject well beyond those prescribed by the Freedom of Information Act, and without the threshhold showing of entitlement required by the Act. It has thus far been unable to have its appeal of the injunction heard.

(Footnote 7 return)
See In re 1820–1838 Amsterdam Equities, Inc., 191 B.R. 18 (S.D.N.Y. 1996) (reversing bankruptcy court injunction against civil and criminal slumlord prosecution); *In re Brennan*, 198 B.R. 445 (D.N.J. 1996) (reversing bankruptcy court injunction enjoining state racketeering and securities fraud suit brought against recidivist violator).

(Footnote 8 return)
When the proposed provisions of the "needs-based" system are read in tandem with the "means-testing" concept, they became the functional equivalent of the threshold eligibility test for bankruptcy relief that has historically eluded the consumer finance industry.

(Footnote 9 return)
The National Bankruptcy Conference is an association of 65 judges, professors and lawyers dedicated to improving federal bankruptcy law and administration. The NBC is grateful to the Congress for regularly having considered its views for over 60 years.