February 16, 2005

Senator Arlen Specter
711 Hart Building
United States Senate
Washington, DC 20510

Senator Patrick Leahy
433 Russell Senate Office Building
United States Senate
Washington, DC 20510

Re: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S. 256)

Dear Senators Specter and Leahy:

We are professors of bankruptcy and commercial law. We are writing with regard to The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S.256)(the "bill"). We have been following the bankruptcy reform process for the last eight years with keen interest. The 92 undersigned professors come from every region of the country and from all major political parties. We are not members of a partisan, organized group. Our exclusive interest is to seek the enactment of a fair, just and efficient bankruptcy law. Many of us have written before to express our concerns about earlier versions of this legislation, and we write again as yet another version of the bill comes before you. The bill is deeply flawed, and will harm small businesses, the elderly, and families with children. We hope the Senate will not act on it.

It is a stark fact that the bankruptcy filing rate has slightly more than doubled during the last decade, and that last year approximately 1.6 million households filed for bankruptcy. The bill's sponsors view this increase as a product of abuse of bankruptcy by people who would otherwise be in a position to pay their debts. Bankruptcy, the bill's sponsor says, has become a system "where deadbeats can get out of paying their debt scott-free while honest Americans who play by the rules have to foot the bill."

We disagree. The bankruptcy filing rate is a symptom. It is not the disease. Some people do abuse the bankruptcy system, but the overwhelming majority of people in bankruptcy are in financial distress as a result of job loss, medical expense, divorce, or a combination of those causes.[1] In our view, the fundamental change over the last ten years has been the way that

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[1] Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (2001); Marianne Culhane and Michaela White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing for Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27, 28 n.8 (1999).

credit is marketed to consumers. Credit card lenders have become more aggressive in marketing their products, and a large, very profitable, market has emerged in subprime lending. Increased risk is part of the business model. Therefore, it should not come as a surprise that as credit is extended to riskier and riskier borrowers, a greater number default when faced with a financial reversal. Nonetheless, consumer lending remains highly profitable, even under current law.

The ability to file for bankruptcy and to receive a fresh start provides crucial aid to families overwhelmed by financial problems. Through the use of a cumbersome, and procrustean means-test, along with dozens of other measures aimed at "abuse prevention," this bill seeks to shoot a mosquito with a shotgun. By focusing on the opportunistic use of the bankruptcy system by relatively few "deadbeats" rather than fashioning a tailored remedy, this bill would cripple an already overburdened system.

1. The Means-test

The principal mechanism aimed at the bankruptcy filing rate is the so called "means-test," which denies access to Chapter 7 (liquidation) bankruptcy to those debtors who are deemed "able" to repay their debts. The bill's sponsor describes the test as a "flexible . . . test to assess an individual's ability to repay his debts," and as a remedy to "irresponsible consumerism and lax bankruptcy law." While the stated concept is fine – people who can repay their debts should do so – the particular mechanism proposed is unnecessary, over-inclusive, painfully inflexible, and costly in both financial terms and judicial resources.[2]

- First, the new law is unnecessary. Existing section 707(b) already allows a bankruptcy judge, upon her own motion or the motion of the United States Trustee, to deny a debtor a discharge in Chapter 7 to prevent a "substantial abuse." Courts have not hesitated to deny discharges where Chapter 7 was being used to preserve a well-to-do lifestyle,[3] and the United States Trustee's office has already taken it upon itself to object to discharge when, in its view, the debtor has the ability to repay a substantial portion of his or her debts.
- Second, the new means-test is over-inclusive. Because it is based on income and expense standards devised by the Internal Revenue Service to deal with tax cheats, the principal effect of the "means-test" would be to replace a judicially supervised, flexible process for ferreting out abusive filings with a cumbersome, inflexible standard that can be used by creditors to impose costs on overburdened families, and deprive them of access to a bankruptcy discharge. Any time middle-income debtors have $100/month more income than the IRS would allow a delinquent taxpayer to keep, they must submit themselves to a 60 month repayment plan. Such a plan would yield a mere $6000 for creditors over five years, less costs of government-sponsored administration.
- Third, to give just one example of its inflexibility, the means-test limits private or parochial school tuition expenses to $1500 per year. According to a study by the

[2] As one commentator has put it: "[T]he new means testing proposal . . . has . . . shifted to a command-and-control approach. Although means testing can be defended in principle – surely, debtors should repay some of their obligations if they can realistically do so – mechanical guidelines are both an artificial and manipulable strategy for inducing debtors to pay." David A. Skeel, Jr., *Debt's Dominion* (2001) at 210.
[3] *See, e.g., In re Kornfield*, 164 F. 3d 778 (2nd Cir. 1999).

National Center for Educational Statistics, even in 1993, $1500 would not have covered the average tuition for any category of parochial school (except Seventh Day Adventists and Wisconsin Synod Lutherans).[4] Today it would not come close for any denomination. In order to yield a few dollars for credit card issuers, this bill would force many struggling families to take their children from private or parochial school (often in violation of deeply held religious beliefs) for three to five years in order to confirm a Chapter 13 plan.

- Fourth, the power of creditors to raise the "abuse" issue will significantly increase the number of means-test hearings. Again, the expense of the hearings will be passed along to the already strapped debtor. This will add to the cost of filing for bankruptcy, whether the filing is abusive or not. It will also swamp bankruptcy courts with lengthy and unnecessary hearings, driving up costs for the taxpayers.
- Finally, the bill takes direct aim at attorneys who handle consumer bankruptcy cases by making them liable for errors in the debtor's schedules.[5]

Our problem is not with means-testing *per se*. Our problem is with the collateral costs that this particular means-test would impose. This is not a typical means test, which acts as a gatekeeper to the system. It would instead burden the system with needless hearings, deprive debtors of access to counsel, and arbitrarily deprive families of needed relief. The human cost of this delay, expense, and exclusion from bankruptcy relief is considerable. As a recent study of medical bankruptcies shows, during the two years before bankruptcy, 45% of the debtors studied had to skip a needed doctor visit. Over 25% had utilities shut off, and nearly 20% went without food.[6] If the costs of bankruptcy are higher, the privations will increase. The vast majority of individuals and families that file for bankruptcy are honest but unfortunate. The main effect of the means-test, along with the other provisions discussed below, will be to deny them access to a bankruptcy discharge.

2. Other Provisions That Will Deny Access to Bankruptcy Court

The means-test is not the only provision in S. 256 which is designed to limit access to the bankruptcy discharge. There are many others. For example:

- Sections 306 and 309 of the bill (working together) would eliminate the ability of Chapter 13 debtors to "strip down" liens on personal property, in particular their car, to the value of the collateral. As it is, many Chapter 13 debtors are unable to complete the schedule of payments provided for under their plan. These provisions significantly raise the cash payments that must be made to secured creditors under a Chapter 13 plan. This will have a whipsaw effect on many debtors, who, forced into Chapter 13 by the means-test, will not have the income necessary to confirm a plan under that Chapter. This group of

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[4] National Center for Educational Statistics, *Private Schools in the United States: A Statistical Profile, 1993-94* (Table 1.5), available at: http://nces.ed.gov/pubs/ps/459t1050.asp.

[5] American Bar Association, *Fact Sheet: Congress Considers Imposing Harsh New Liability Standards Against Bankruptcy Attorneys* (December 2004), available at: http://www.abanet.org/poladv/priorities/brattyliabilityfactsheet_december2004_.pdf .

[6] David U. Himmelstein, Elizabeth Warren, Deborah Thorne, and Steffie Woolhandler, *Illness and Injury as Contributors to Bankruptcy*, HEALTH AFFAIRS (2005), available at: http://content.healthaffairs.org/cgi/reprint/hlthaff.w5.63v1.

debtors would be deprived of any discharge whatsoever, either in Chapter 7 or Chapter 13. In all cases this will reduce payments to unsecured creditors (a group which, ironically, includes many of the sponsors of this legislation).

- Section 106 of the bill would require any individual debtor to receive credit counseling from a credit counseling agency within 180 days prior to filing for bankruptcy. While credit counseling sounds benign, recent Senate hearings with regard to the industry have led Senator Norm Coleman to describe the credit counseling industry as a network of not for profit companies linked to for-profit conglomerates. The industry is plagued with "consumer complaints about excessive fees, pressure tactics, nonexistent counseling and education, promised results that never come about, ruined credit ratings, poor service, in many cases being left in worse debt than before they initiated their debt management plan."[7] Mandatory credit counseling would place vulnerable debtors at the mercy of an industry where, according to a recent Senate investigation, many of the "counselors" are seeking to profit from the misfortune of their customers.[8]
- Sections 310 and 314 would significantly reduce the ability of debtors to discharge credit card debt and would reduce the scope of the fresh start, for even those debtors who are able to gain access to bankruptcy.

The cumulative effect of these provisions, and many others contained in S. 256 (along with the means-test) will be to deprive the victims of disease, job loss, and divorce of much needed relief.

3. <u>The Elusive Bankruptcy Tax?</u>

The proponents of S.256 argue that the bill is good for consumers because it will reduce the so-called "bankruptcy tax." In their view, the cost of credit card defaults is passed along to the rest of those who use credit cards, in the form of higher interest rates. As the bill's sponsor dramatically puts it: "honest Americans who play by the rules have to foot the bill." This argument seems logical. However, it is not supported by facts. The average interest rate charged on consumer credit cards has declined considerably over the last dozen years. More importantly, between 1992 and 1995, the spread between the credit card interest rate and the risk free six-month t-bill rate declined significantly, and remained basically constant through 2001.[9] At the

[7] Statement of Senator Norm Coleman, Hearing of the Senate Permanent Commission on Investigations (March 24, 2004), available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:93477.wais.

[8] *Id.*

[9] Mark Furletti, *Credit Card Pricing Developments and their Disclosure* (Federal Reserve Bank of Philadelphia, January 2003), available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=572585.

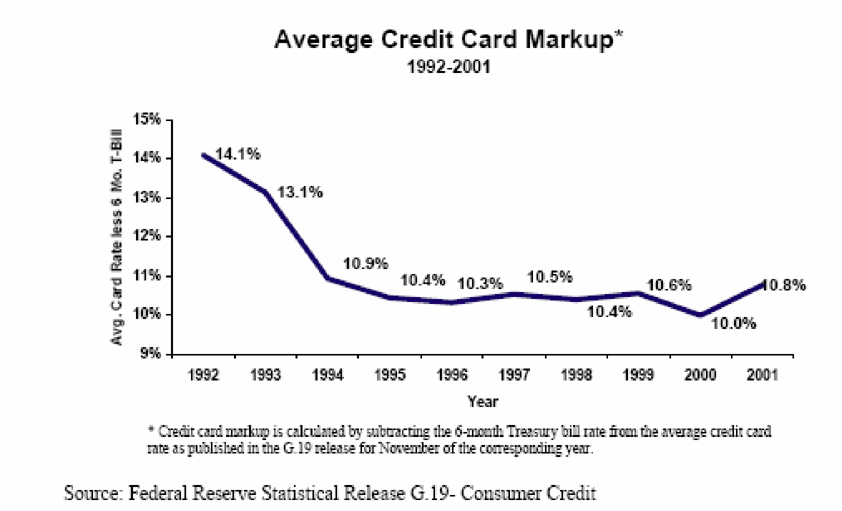
same time, the profitability of credit card issuing banks remains at near record levels.[10]

Thus, it would appear that hard evidence of the so-called "bankruptcy tax" is difficult to discern. That the unsupported assertion of that phenomenon should drive Congress to restrict access to the bankruptcy system, which effectuates Congress's policies about the balance of rights of both creditors and debtors, is simply wrong.

4. Who Will Bear the Burden of the Means-test?

The bankruptcy filing rate is not uniform throughout the country. In Alaska, one in 171.2 households files for bankruptcy. In Utah the filing rate is one in 36.5. The states with the ten highest bankruptcy filing rates are (in descending order): Utah, Tennessee, Georgia, Nevada, Indiana, Alabama, Arkansas, Ohio, Mississippi, and Idaho.[11] The deepest hardship will be felt in the heartland, where the filing rates are highest. The pain will not only be felt by the debtors themselves, but also by the local merchants, whose customers will not have the benefit of the fresh start.

The fastest growing group of bankruptcy filers is older Americans. While individuals over 55 make up only about 15% of the people filing for bankruptcy, they are the fastest growing age group in bankruptcy. More than 50% of those 65 and older are driven to bankruptcy by medical debts they cannot pay. Eighty-five percent of those over 60 cite either medical or job problems as the reason for bankruptcy.[12] Here again, abuse is not the issue. The bankruptcy filing rate reveals holes in the Medicare and Social Security systems, as seniors and aging members of the baby-boom generation declare bankruptcy to deal with prescription drug bills, co-pays, medical supplies, long-term care, and job loss.



[10]Board of Governors of the Federal Reserve System, *The Profitability of Credit Card Operations of Depository Institutions* (June 2004), available at: http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2004/ccprofit.pdf.

[11] Source: American Bankruptcy Institute. Available at: http://www.abiworld.org/statcharts/HouseRank.htm

[12] Melissa B. Jacoby, Teresa A. Sullivan, & Elizabeth Warren, *Rethinking the Debates over Health Care Financing: Evidence from the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375, 397-399 (2001); Elizabeth Warren, *Older Americans in Bankruptcy* (October 12, 2004)(working paper). *See also*, Teresa A. Sullivan, Elizabeth Warren, Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* (2001) at 165.

Finally, it is crucial to recognize that the filers themselves are not the only ones to suffer from financial distress. They often have dependents. As it turns out, families with children – single mothers and fathers, as well as intact families – are more likely to file for bankruptcy than families without them. In 2001, approximately 1 in 123 adults filed for bankruptcy. That same year, 1 in 51 children was a dependent in a family that had filed for bankruptcy.[13] The presence of children in a household increases the likelihood that the head of household will file for bankruptcy by 302%.[14] Limiting access to Chapter 7 will deprive these children (as well as their parents) of a fresh start.

Conclusion

S. 256 contains a number of salutary provisions, such as the proposed provisions that protect consumers from predatory lending. Our concern is with the provisions addressing "bankruptcy abuse." These provisions are so wrongheaded and flawed that they make the bill as a whole unsupportable. We urge you to either remove these provisions or vote against the bill.

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[13] Elizabeth Warren, *Bankrupt Children*, 86 MINN. L. REV. 1003, 1011 (2002).
[14] *Id.*at 1013.

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