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Bankruptcy [2]

Bankruptcy

cc: Nicole

HARVARD LAW SCHOOL

CAMBRIDGE · MASSACHUSETTS · 02138

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May 19, 1998

Hillary Clinton
Office of the First Lady
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20373

Dear Mrs. Clinton:

It was a pleasure to meet with you in Boston on May 1. I have since read your column on bankruptcy. It was a terrific statement of the issues and illustration of the very real problems facing American families.

I have continued to work on the bankruptcy issues, meeting with Senators Kennedy, Dodd, Feingold and Durbin and doing what I can to support their work. The senators and their staffs have been tireless, but the lobbying from the credit card companies has been intense. I am uncertain about how much they will be able to accomplish in the Senate.

As you know, the House has already passed the bill out of the Judiciary Committee--adding on still more special interest provisions. The Committee rejected fundamental protections for families, such as a provision to make certain that medical expenses the debtor must pay for his own care, for the care of his spouse or dependent, or for an elderly parent are included in necessary expenses when calculating eligibility for chapter 7. The Committee rejected an amendment to the "means test" to make certain that income from social security payments, disability payment or veteran pension payments would not force someone into a seven year repayment plan. The list goes on, but the spirit of the bill is unmistakable. This bill is designed to help large creditors squeeze more money out of families already stressed to the breaking point.

I appreciate the time you have spent on the bankruptcy issues. You have helped give a voice to the million and a half families who will use this system this year to try to stabilize their failing economic circumstances. Please continue to help them.

If I can be helpful in any way, please let me know.

Very truly yours,

Elizabeth Warren

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Leo Gottlieb Professor of Law

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MEMORANDUM

TO: LAURA ROSEN, NATIONAL ECONOMIC COUNCIL

FROM: ELIZABETH WARREN EW

DATE: MAY 19, 1998

I'm sure you have heard that the House claims to have "fixed" the issues that affect single parents in H.R. 3150. They have not. The changes have not ended the post-bankruptcy competition for the ex-spouse's money; instead, they have increased it. The changes have also tangled the Chapter 13 priority for support payments even worse, putting support recipients at much greater risk than they face under current law.

Melissa Jacoby has put together a brief outline on the difficulties with H.R. 3150 as they relate specifically to collection of child support. I'm attaching a copy for you.

Please let me know if I can be helpful in any way.

The Effect of H.R. 3150[1] on Single Parent Families

H.R. 3150 has been criticized for its effects on single parents and children, both as debtors and as creditors trying to collect past-due support. The provisions producing these concerns generally do not explicitly mention ex-spouses, children or support obligations; rather, the especially problematic provisions are those that increase dividends and collection rights for nonpriority unsecured creditors (such as credit card lenders) at the expense of priority creditors (such as child support recipients) and secured creditors.

In response, defenders of H.R. 3150 have emphasized that the legislation does not directly lower the priority of support obligations and that allegations of adverse effects have been fabricated for political reasons. At the same time, the proponents have made a set of amendments with the express purpose of protecting support obligations.

Although H.R. 3150 does not explicitly lower the priority of support obligations, provisions throughout the bill would have an adverse impact on the ease of collection for support recipients and other similar types of creditors due to increased competition for resources, heightened administrative costs, and changes to Chapter 13 repayment. While the legislation includes some amendments that may enhance the legal status of support obligations, the amendments are cosmetic at best. Rather than clearing the way for women and children to collect past due and current support obligations, the new provisions would be ineffectual in practice or actually would hinder the ability of women and children to collect support obligations because those provisions also would increase competition for scarce resources by expanding the priority and nondischargeability of additional debts to the states[2] and of nonsupport debts. Moreover, some of the provisions designed to ensure payment to support recipients conflict with other provisions in the legislation that mandate contrary treatment.

Further expansion of priority and nondischargeable debts that would compete with debts owed to support recipients in and after bankruptcy

Increased competition with credit card companies and retailers

Sections 141, 142, and 145 of H.R. 3150 would make many credit card debts and retail charge card debts survive bankruptcy and would provide some of those debts with priority status. Section 141 would except from discharge any debts incurred to pay debts that would have been nondischargeable had they not been paid upon the filing of the bankruptcy case. Since debts incurred to pay priority debts would be "payable in the higher order of priority (if any) as the

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[1]As reported out of the Committee on the Judiciary, May 14, 1998.

[2]While the states and individual support recipients share the same general goal of collecting support obligations, their interests are not co-extensive, particularly in the context of a financially distressed debtor.

respective claims paid by incurring such debts," a credit card debt for a debt in the nature of support would share seventh priority status pro rata with other obligations owed directly to the support recipients. The provision also appears to accord priority status to debts incurred to pay nonpriority nondischargeable debts. This means that if a debtor pays a parking ticket with a credit card prior to bankruptcy, that credit card debt would be a nondischargeable priority debt in Chapter 7. Since all priority debts must be repaid in full in Chapter 13, the credit card debt would get an increased share of the debtor's resources in Chapter 13, to the detriment of other priority and secured. Thus, without a compelling policy justification, section 141 would produce competition among creditors for scarce resources within Chapter 13, within Chapter 7, and after bankruptcy.

Under section 142, any consumer debt incurred within 90 days prior to filing would be presumed nondischargeable except for "consumer debts owed to a single creditor which are incurred for necessaries and aggregate $250 or less." This expansion of credit card debt nondischargeability would produce additional competition with institutional lenders for debtors' postbankruptcy resources without a policy justification. While proponents of the legislation emphasize that the 90 day provision is a presumption and not an absolute imposition of nondischargeability, this distinction overlooks the reality of consumer bankruptcy law and practice. It is extremely simple for a creditor to file (or to threaten to file) an adversary proceeding alleging nondischargeability, and most consumer debtors cannot afford the litigation necessary to rebut a legal presumption and instead are likely to concede nondischargeability or reaffirm their liability for the debt. Rebutting this presumption would consume financial resources that otherwise should be directed toward important expenses such as support or housing obligations. The $250 "necessaries" carve-out does not change the practical effect of this provision. Proving that such debts were for "necessaries" imposes the same costs as the presumption. Regardless of the merits, most debtors are unlikely to contest such a nondischargeability claim.

Increasing the benefits for credit card lenders and heightening the debtor's postbankruptcy debt burden, section 145 of H.R. 3150 would amend 11 U.S.C. § 523(a)(2) so that even more credit card debts would be nondischargeable without requiring credit card lenders to prove the elements of fraud. The credit card lender merely would have to allege that the borrower used a credit card "without a reasonable expectation or ability to repay" unless access to such credit was extended without an application and a reasonable evaluation of the debtor's ability to repay. Section 145 also would amend subsection (B) of section 523(a)(2) so that lenders would not have to allege that a debtor intended to deceive the lender with a written representation, replacing the requirement with "without taking reasonable steps to ensure the accuracy of the statement."[3] These amendments would widen the scope of nondischargeable debts even further without a sound policy basis and would heighten overreaching by aggressive creditors to obtain reaffirmation agreements. The recently-added carve-out for unsolicited and unwise credit

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[3] It is unclear why the creditor's burden of proof should be relaxed in section 523(a)(2)(B), which generally has been perceived to work well. Relaxing this requirement will lead to even more concessions of nondischargeability for credit card debt.

extensions would have little, if any, effect on the vast majority of proceedings. Lenders no longer are permitted to send actual credit cards until a debtor completes an application. Moreover, whether the creditor conducted an evaluation of the debtor's ability to pay or increased one's credit limit without a request are questions of fact that generally would require litigation.

Exacerbating the effect of sections 142 and 145, section 143 of H.R. 3150 would make these credit card debts nondischargeable in Chapter 13 even after a Chapter 13 debtor has made plan payments for 3, 5, or even 7 years.[4] Chapter 13 debtors would have greater economic motivation to litigate the nondischargeability of these debts than Chapter 7 debtors since they essentially would be spending the money of other creditors. Thus, expanding Chapter 13 nondischargeability would increase administrative costs and delay the Chapter 13 process through litigation at the expense of other creditors.

Taken together, sections 141, 142, 143, and 145 could promote extensive and costly litigation and provide a basis for creditor overreaching without a legitimate public policy reason to make these debts survive bankruptcy. Increasing the number of nondischargeable credit card debts is likely to have an adverse impact on the ability of debtors to be able to pay nondischargeable support obligations, not to mention student loans, taxes, car payments, and mortgage payments. This effect is exacerbated by the fact that H.R. 3150 does not do anything to protect support recipient creditors from having to compete with improvidently "reaffirmed" debts. Reaffirmations enable any debt to survive bankruptcy if a creditor can convince the debtor to assent to such treatment. *See* 11 U.S.C. § 524(d). If anything, H.R. 3150 would provide more leverage for unsecured lenders to request reaffirmations and thus increases the likelihood that a debtor will reaffirm unsecured or nominally secured debts to credit card companies and retailers, producing greater strains on his income after bankruptcy. Such additional strains on the debtor's postbankruptcy budget will not be in the best interest of the debtor, his dependents, or any of his other creditors.

Increased competition with the government

Section 146 of H.R. 3150, one of the provisions that purportedly protects support recipients, would further increase competition for debtors' resources by expanding the size of government claims and enhancing the government's rights to collect on claims in Chapter 7, in Chapter 13, and after bankruptcy. By increasing the size of the state claims and providing priority status, these provisions would, in some cases, reduce the distributions available for children and ex-spouses in the bankruptcy process itself and on a going-forward basis.[5]

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[4]Debts falling within the scope of section 141 (debts incurred to pay nondischargeable debts) would not be excepted from the superdischarge under this provision, but this is not relevant since they would have to be paid in full in Chapter 13 on account of their new priority status.

[5]Although section 147 of H.R. 3150 would amend 11 U.S.C. § 523(a)(5) to ensure nondischargeability for property settlements that are not "in the nature of support," which would be helpful in some situations, this amendment does not change the fact that this legislation

While H.R. 3150 would expand the legal rights of support recipients to pursue collection out of otherwise exempt assets, it would restrict the beneficial effects of the expansion by granting even more latitude to government creditors to pursue the same property. Section 146 of H.R. 3150 would amend section 522[6] to provide that debts to the state that are nondischargeable under 11 U.S.C. § 523(a)(18) could be collected out of otherwise-exempt property, as support debts owed to individuals may be collected under current law. Section 502 of H.R. 3150 would amend that section further to permit nondischargeable support obligations and taxes to be collected from any exempt property, notwithstanding any federal or state law to the contrary.[7] The broad preemption language of this provision would nullify wage exemptions, federal wage garnishment laws, and exemptions in section 6334 of the Internal Revenue Code and comparable state laws that limit the property that can be seized by taxing agencies to satisfy a tax debt. For example, while the Internal Revenue Code would exempt wearing apparel and school books from levy to satisfy a tax debt, this amendment would allow the IRS to seize school books and sell them. Section 507 of H.R. 3150 would expand the scope of the government's authority to seize the debtor's property even further by excluding 11 U.S.C. § 523(a)(1) nondischargeable tax debts from the Chapter 13 superdischarge, thereby allowing additional government debts to be collected out of exempt property.[8] Thus, although these changes contain a partial expansion in the legal rights against the debtor's property if the ex-spouses have the resources and legal representation to avail themselves of this remedy (and if the debtor has sufficiently valuable property), any benefit probably is outweighed by the substantial increase in authority provided to government entities, which have far greater resources to pursue this exempt property.

Increased competition with secured creditors

To the extent that the legislation is moving toward high valuation of collateral, or the elimination of the Chapter 13 "cramdown" altogether, support recipients would be disadvantaged as well.

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produces increased competition for the ex-spouse in collecting her debts from the state and from institutional lenders. In addition, the section 523(a)(5) amendment could have odd unintended consequences in some cases. For example, if a debtor has been married and divorced twice and pursuant to his divorce decrees he owes support obligations to his second ex-wife and child and owes business debts to his first ex-wife who is a successful entrepreneur, this provision would elevate the business debts to the status of his support obligations to his second wife, who would face additional increased competition for the debtor's resources from another ex-spouse who does not need support.

[6]The bill refers to section 522(b), but the proposed language leads to the conclusion that the bill intends to amend section 522(c).

[7]It is unclear how this amendment should be reconciled with the amendment section 146.

[8]Debts that are nondischargeable under 11 U.S.C. § 523(a)(1) can be collected out of exempt property.

Several provisions that inflate the valuation of certain secured claims also would have an adverse impact on distributions for children who are creditors in their non-custodial parents' bankruptcy cases. Secured claims generally are divided into secured and unsecured portions to reflect economic reality and to promote fair and equitable treatment of creditors in the bankruptcy process. *See* 11 U.S.C. § 506. Under section 128 of H.R. 3150, the usual valuation rules would be inapplicable to purchases made within 180 days prior to bankruptcy, for which the secured claim would include the outstanding balance, interest, and charges at the contract rate, giving the secured creditor better treatment in bankruptcy than under state law. For the valuation of other personal property collateral, section 129 of H.R. 3150 would set the valuation of personal property collateral at "replacement value," to be defined as the price a retail merchant would charge for property of that kind, age, and condition, with no deductions for marketing or sales costs. This is a very high valuation standard that in many instances is the least advantageous for other creditors.[9] Inflated secured claims, in combination with the proposed mandatory unsecured debt payments, will make it all the more difficult to stretch the debtor's budget to pay other obligations. Rather than penalizing the debtor,[10] in many cases this inflated valuation standard -- or the elimination of the "cramdown" power in consumer cases altogether -- actually would divert resources away from priority claimants, such as child support recipients, and from general unsecured creditors.

Aside from increasing competition, the valuation standards, in combination with other new requirements governing secured claims, may have other effects on the debtor's ex-spouse and children. As the requirements governing secured debt become more onerous and preclude debtors from keeping their cars,[11] even a diligent debtor may lose his job if he cannot get to his workplace and thus will fall behind on his support obligations to his ex-wife and children. Alternatively, a Chapter 13 debtor may be trying to cure a default on a car that he is required to maintain for use by his ex-wife as part of her maintenance and support, and in such a case, inflated

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[9]The proposed amendment apparently would overrule the United States Supreme Court's determination in *Associates Commercial Corp. v. Rash*, 117 S. Ct. 1879 (1997), that debtors should not have to give value for attributes they did not receive (*e.g.*, reconditioning, preparation, sales commissions, warranties, storage, inventory costs, and advertising).

[10]While this provision was intended to penalize debtors who purchased property in contemplation of bankruptcy, it actually would benefit more sophisticated debtors who sought to avoid chapter 13, since it will make debtors less likely to be able to pay 20% of his nonpriority unsecured claims.

[11]Another example of such a provision is section 162 of H.R. 3150. This provision would require a debtor to make cash payments to lessors and creditors with debts secured by personal property until the creditors started receiving plan payments. Since trustees do not immediately disburse distributions to creditors, this section would require debtors to make adequate protection payments concurrently with plan payments in the beginning of a plan, which would be impossible given the calculation of the plan payments.

valuation may result in the loss of the ex-wife's form of transportation.[12]

Postbankruptcy priority for support obligations does not resolve the problem

In response to concerns raised regarding the effects of many provisions of H.R. 3150 on the support recipients, the House Judiciary Committee added another provision that purports to preserve the priority of support obligations after the debtor has emerged from bankruptcy. This amendment appears to deal with past due, not current, support obligations, and thus does not speak to the essential competition problem for support expenses going forward. Putting aside the very questionable Constitutional foundation for this provision, this amendment is not likely to provide any substantial benefits to support recipients. Collection activities often proceed informally. The fact that one unsecured debt has legal "priority" over another debt is irrelevant if no legal process is ever invoked. Thus, if one creditor has greater resources to exercise more leverage than another, the well-financed aggressive creditor may get paid first without ever having to resort to judicial process and is perfectly entitled to do so in the state law collection system. In addition, unless two creditors actively are seeking to attach, garnish, or execute on the same property, it is unclear how state courts will be able to ensure that a priority debt gets paid ahead of another debt unless a complex noticing system for unsecured claims is developed, which would be ineffective if support recipients did not know that they had to record their claims. In addition, the fact that unpaid support obligations would be given priority does not mean that they support recipients can enforce them. They would have to find the ex-husband and hire an attorney to enforce the order, who would have to determine how to reduce the orders to judgment in the appropriate state, and then find assets to attach. It is unclear whether this amendment would entitle a support recipient to sue the other nondischargeable creditor, such as a credit card company, to collect her payments, but even that remedy is dependent on time, resources, and legal representation.

As a general matter, the postbankruptcy priority of debts becomes irrelevant if debtors leave the bankruptcy system more debt-laden than ever before. To the extent that an individual emerges from bankruptcy with overwhelming debts, the legislation will increase his incentives to go underground, leave his job, move to another jurisdiction, and get paid on a cash basis, rendering postbankruptcy priority utterly useless.

Requirement to pay support obligations

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[12]This effect is exacerbated, in part, by section 144 of H.R. 3150, which would cut back substantially on co-debtor stay protection and allow creditors to act unilaterally to possess property that is not within the control of the debtor. A recent adjustment to section 144 is designed to preserve the co-debtor stay if the debtor is obliged to maintain property for his ex-spouse under a divorce decree or separation agreement. This adjustment is well-meaning, but will not prevent creditors from taking actions against the ex-spouse co-debtor if the creditor is unaware of the terms of the divorce decree.

As a condition of confirming a repayment plan, section 146 of H.R. 3150 would require a debtor to pay all support obligations that "are due after the date the petition is filed." Postpetition payment of support obligations in a repayment plan would be a condition of receiving a bankruptcy discharge. However, section 102 of H.R. 3150 explicitly excludes "payments for debts" from the IRS budget allowance and 11 U.S.C. 502(b)(5) disallows claims for debts that are unmatured on the date of the bankruptcy petition. Thus, a literal reading of the H.R. 3150 payment plan rules would exclude pending child support payments altogether. In addition, family court orders sometimes address arrearages and pending child support obligations; if such an order was at issue in a case, section 146 would require the debtor to pay arrearages and pending child support before confirming a plan, but section 102 would provide contrary instruction to spread the child support arrearage over 60 months. The explicit conditions for plan payments in section 102 of the bill effectively preclude prompt payment of past due support obligations that normally occurs under current law and would require support recipients (and other priority and secured creditors) to wait 5 years to receive their payments on past due debts. The net income "produced" from requiring deferred payments to priority creditors would be dedicated to credit card debts and other nonpriority unsecured debts.

Rather than re-evaluate and adjust the payment requirements, the House Judiciary Committee instead appended language to the end of section 102 stating that nothing shall prevent the payment of obligations with priority under 11 U.S.C. § 507 and that the plan shall specify how payments to other creditors will be accordingly adjusted. This admonition cannot be reconciled with the other requirements of this subsection dictating the calculation of all plan payments, each of which is dependent partially on the others. Corresponding adjustments to the plan will likely make the plan unconfirmable, or at the very least, infeasible. In addition, this provision does not resolve the exclusion of current support obligations in the Chapter 13 budget, notwithstanding the precatory language in section 146 of the bill.

Additional automatic stay exceptions to permit pursuit of debtor

Section 146 of H.R. 3150 also would amend 11 U.S.C. § 362(b) so that the automatic stay would not enjoin actions to impose or enforce a wage order for domestic support obligations. This provision would obviate the need for parties to seek relief from the stay, and thus could minimize costs. Of course, since wage assignments may be for debts owed to the state rather than to the ex-spouse or child directly, in some cases this automatic stay exception would divert funds away from individual support recipients. In addition, an automatic stay exception for wage orders may have limited efficacy, as many bankruptcy cases with claims for domestic support obligations do not involve wage orders. Wage assignments are not always easy or inexpensive to obtain; the ability to obtain a wage order depends on the laws of a given state and whether the ex-spouse's employment situation makes this possible. Since individuals who file for bankruptcy are likely to have experienced a prebankruptcy period of unemployment or marginal employment for cash payment, the likelihood of having a wage assignment declines. Moreover, a wage order or license revocation may be useless if a financially troubled ex-spouse cannot shed his high interest unsecured debts; restrictions on access to Chapter 7, along with this continuing postbankruptcy debt burden, will increase a debtor's incentives to leave his job, move to another jurisdiction, and get paid on a cash basis. Thus, while permitting continued wage garnishment for this purpose may be helpful, it falls short of addressing the detrimental impact of this legislation on single parents and children.

This section also would amend 11 U.S.C. § 362(b) so that the automatic stay would not enjoin actions to withhold, suspend, or restrict licenses of the debtor for his delinquency in support obligations. In the case of a Chapter 13 debtor who diligently is attempting to catch up on support payments, license revocation may work against support recipients if the lack of transportation causes the debtor to lose his job, particularly because the debtor would not be allowed to pay the delinquency up front under section 102 of H.R. 3150. For this reason, court discretion may be preferable.

Increased administrative costs and time delays divert resources from support payments

H.R. 3150 is replete with provisions that would make bankruptcy relief more complicated and expensive. For example, two initial hurdles, the means test and the consumer credit counseling prerequisite, would necessitate litigation over eligibility for bankruptcy relief in nearly every consumer bankruptcy case. *See* H.R. 3150 §§ 101, 104. Considerable additional administrative requirements also would increase the costs of bankruptcy. Filing fees and lawyer fees inevitably would consume resources that otherwise could be directed toward creditors and necessary expenses, and excessive litigation would delay payouts to support recipients and other creditors.

Conclusion

Notwithstanding amendments designed to ameliorate concerns about support obligations, H.R. 3150 as reported out of the House Judiciary Committee would adversely affect support recipients and other similar creditors by increasing the number of nondischargeable and priority debts, inflating the valuation of secured claims, providing conflicting authority for the treatment of support obligations in Chapter 13, and generally increasing the amount of resources consumed in administrative costs.[13] For reasons stated elsewhere, many portions of H.R. 3150 are troublesome for single parent families who use bankruptcy as debtors as well. Divorced women already are disproportionately represented in bankruptcy; to the extent that their financially troubled spouses cannot obtain adequate debt relief, the number of divorced women resorting to bankruptcy is likely to increase.

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[13] The sections discussed are only illustrative of the many provisions of H.R. 3150 that would have an adverse effect on creditors. A more exhaustive list would include, but not be limited to, sections 101, 102, 103, 121, 123, 125, 128, 129, 130, 141, 142, 143, 144, 145, 146, 147, 148, 407, 409, and 507.

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Consumer Bankruptcy: Issues Summary

Professor Elizabeth Warren
Leo Gottlieb Professor of Law
Harvard Law School
April 2, 1998

The Rise in Filings

This year about 1.4 million families will file for consumer bankruptcy, a rise of about 400% since 1980.

Virtually all independent academic studies and all government studies of the increase in bankruptcy demonstrate that the rise in bankruptcy filings follows equally sharp rises in the amount of consumer debt per household. Bankruptcy filings began a sharp upward climb in 1986, with a slight dip in the early 1990s, followed by a steeper rise since 1994. This pattern closely tracks increases in consumer debt. As families carry more short-term, high interest credit card and similar debt, they are more at risk for financial failure. Because they have almost no savings and have already incurred as much debt as they can reasonably expect to repay, they have no cushion to help them survive a crisis. For a family loaded with debt, any set back--such as a job loss, an uninsured medical loss, or a divorce--will put the family over the edge of financial stability.

New academic research demonstrates that, as a group, the debtors who file for bankruptcy in the mid-1990s are worse off than their counterparts who filed in the early 1980s. Their incomes are lower and their debt loads are higher. These data suggest that, as a group, Americans are less willing to declare bankruptcy; they file when they are so pressed financially that they have no alternative.

Who Files?

Bankrupt debtors are a cross-section of America. People who file for bankruptcy have educational levels on par with all other middle class Americans. They work in the same occupations and in the same industries as other middle class Americans. They are employed and they own homes in roughly similar proportions to all other Americans. By every social measure, bankruptcy is a middle class phenomenon. They differ from their neighbors in that their incomes are substantially lower and their debts are substantially higher.

While the bankruptcy filers are a cross-section of middle class America, they are the most vulnerable among American families. They have been the hardest hit by economic reversals, and they are using bankruptcy as to gain a foothold to stop their slide into the lower class. Among the subgroups in bankruptcy are:

Older Americans Because they take on less consumer debt per household, older Americans end up in bankruptcy less frequently than their younger counterparts. When they do file, however, a larger fraction--nearly 40%--explain that they are driven to bankruptcy by medical debts they cannot pay. Older Americans also suffer from job losses and job erosion, so that two-thirds of the debtors aged 50-65 cite either a medical reason or a job reason for their bankruptcy filings.

Women Raising Families Both men and women are more likely to declare bankruptcy following divorce. Collectively, the bankruptcy sample has 300% more divorced people than the population generally. Families already laden with consumer debt cannot divide their income to support two households and survive economically. But women, often those rearing families, are hit the hardest. Divorced women file for bankruptcy in greater proportions than divorced men, using the bankruptcy courts to shed credit card and other debts so they can concentrate their incomes on paying current expenses.

Unemployed workers More than half the debtors who file for bankruptcy report a significant period of unemployment preceding their filings. For single-parent households, a period of unemployment can be devastating. Married couples fare slightly better, but do not escape employment problems; more than half the married couples in bankruptcy reported that both the husband and the wife were unemployed preceding the bankruptcy filing.

African American and Hispanic American Families Both African American and Hispanic American middle class families are over-represented in bankruptcy. They report the same problems of job loss and medical debts as their middle class white counterparts, but in greater numbers overall. For African American and Hispanic American families, the home represents a greater portion of their total family wealth and their savings toward retirements than their white counterparts who are more likely to have other assets, such as retirement plans, stock portfolios, other real estate investments, etc. A larger fraction of African American and Hispanic American homeowners use bankruptcy to prevent losing their homes.

What Does Bankruptcy Do For These People?

A family that files for Chapter 7 bankruptcy discharges all its short-term, high interest debt, principally credit card and finance company debt, along with some medical debts. After bankruptcy, however, the family must continue to make *all* payments on the family home, including interest, late charges, and penalties, or they will lose their homes. They must also pay off any second or third mortgages, plus any home equity lines of credit, or risk losing the house.

Debt secured by a home mortgage or home equity line of credit cannot be "stripped down" or reduced in any way in bankruptcy. Most families will also continue to make car payments; they need their cars and they will lose them if they don't pay in full. Families also must pay their tax debts and educational loans after bankruptcy. Those who have outstanding child support or alimony obligations must also pay those in full; none of these debts is dischargeable. In addition, if the debtors sign a reaffirmation agreement to pay any debts that would otherwise be discharged in bankruptcy, they will be legally obligated to do so.

Thus, for most families, Chapter 7 is not total debt relief. If is only an opportunity to concentrate their incomes on their current budgets and to save their homes and cars, make alimony and child support payments, and take care of back taxes and education loans. They leave the bankruptcy courthouse heavy with debt obligations.

The creditors that survive the Chapter 7 bankruptcy filing are dealing with a debtor who is more stable financially and more able to repay those debts. The home mortgage lender is more likely to collect, as are the ex-spouse and the IRS. To the extent that financially troubled debtors are kept out of the bankruptcy system, they are less likely to stabilize financially and make these payments. Even if the debtor successfully files for chapter 7, if more creditors are permitted to survive the Chapter 7 without a discharge, then these additional creditors compete for the debtor's limited funds, again reducing the likelihood of repayment for mortgage. This final point hits ex-spouses particularly hard because they lack the collection leverage of the mortgage or car lenders (repossession) or the IRS (property seizure).

Chapter 13 debtors are those who volunteer to pay some portion of their debts over three to five years. For over fifteen years, however, the two out of three of the debtors who file for Chapter 13 do not make it through a repayment plan. Many face repeated unemployment and some encounter significant unanticipated expenses. For many, however, the reason is simple: they do not earn enough money. When their Chapter 13 repayment plans fail, most debtors leave the bankruptcy system without having discharged any debt. Today, Chapter 13 provides little relief for many of those who try to repay.

The Data

The data about consumer filings and consumer debt are collected by several government agencies and widely reported. A number of academic studies have reported on the correlations. These data are available for citation.

The data about the economic profile of consumers in bankruptcy will be reported at 73 INDIANA LAW JOURNAL 1079 (forthcoming 1998). These data come from two research projects by my coauthors, Dr. Teresa Sullivan, Vice-President of the University of Texas, Professor Jay Westbrook, Benno C. Schmidt Chair of Business Law at the University of Texas, and I, data provided by Judge Barbara Sellers, and a research project by Professors Marianne Culhane and Michaela White of Creighton Law School. The data reported here build on a report made by my coauthors and I in *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-91*, 68 AMERICAN BANKRUPTCY LAW JOURNAL 121 (1994).. These data are available for citation.

The data about the demographic groups that file for bankruptcy are from a study by my coauthors, The data will be reported more fully in our forthcoming book, *The Fragile Middle Class*, to be published next year by Yale University Press. A preliminary report on these data has been made available only as background for understanding the current bankruptcy policy debates. These data are not available for citation or circulation.

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May 22, 1998

Hillary Clinton
Office of the First Lady
The White House
1600 Pennsylvania Avenue
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Dear Mrs. Clinton:

Judge Lisa Fenning, our mutual friend, called me after your meeting with her on Wednesday. She said she thought you would find helpful some basic information about the consumer credit industry and credit card issuers in particular. I prepared the attached list for your use.

If you have been following the legislation, you have probably observed that the Senate bill (S. 1301) has been amended so that it more closely resembles the House bill (H.R. 3150). The Senate Judiciary Committee approved S. 1301 yesterday. Both bills have become even more pro-creditor, and both are now far more technically jumbled, so that, independently of the policy choices, they are simply bad pieces of legislation.

The people you help most with your interest in this legislation are single parents, the elderly, the unemployed, the uninsured, African American and Hispanic American families--the most vulnerable middle class Americans. Thank you for taking the time to discuss these issues with me in Boston earlier this month. I enjoyed meeting you very much and take great comfort in your interest dedication. If I can be helpful in any additional way, please feel free to call on me at any time.

Very truly yours,

Elizabeth Warren

Elizabeth Warren
Leo Gottlieb Professor of Law

Facts About Consumer Debt

Studies by the Congressional Budget Office, the Federal Deposit Insurance Corporation, and independent economists link the rise in consumer bankruptcies directly to the rise in consumer debt.[1]

Deregulation of consumer credit interest rates have not produced a sustained decrease in interest rates. Instead, deregulation has prompted aggressive marketing and a loosening of underwriting standards that have caused a rise in consumer bankruptcies.[2]

Three-quarters of all households have at least one credit card, and three out of four of them also carry credit card debt from month to month.[3]

The growth of credit card loans has been faster than any other type of consumer loans since 1993. Credit card debt doubled in just four years: The amount of credit card loans outstanding at the end of 1997 was $422 billion, twice as much as the amount in 1993.[4]

Credit card usage has grown fastest in recent years among debtors with the lowest incomes. Since the early 1990s, Americans with incomes below the poverty level nearly doubled their credit card usage, and those in the $10,000-25,000 income bracket come in a close second in the rise in debt. The result is not surprising: 27% of the under-$10,000 families have consumer debt that is more than 40% of their income. Nearly one in ten has at least one debt that is more than sixty days past due.[5]

There are well over a billion cards in circulation – a dozen credit cards for every household in the country.[6]

From 1994 through 1996, credit card issuers mailed more than two and a half billion card solicitations each year. This means more than 41 mailings went out each year to every American household--not counting telephone solicitations. Based on industry estimates, those offers add up to about $243,000 of credit per household per year. At this rate, in a little over four years, the credit card companies have offered about a million dollars of credit to every household in the United States.[7]

In 1997, mailed credit card solicitations jumped by 20% to three billion.[8]

Direct solicitation of both college and high school students has intensified in the past two years. Cards are available at many colleges to almost any student -- no income, no credit history and no parental signature required.[9]

Industry analysts estimate that, using a typical minimum monthly payment rate on a credit card, it would take 34 years to pay off a $2,500 loan, and total payments would exceed 300% of the original principal. Credit card statements, unlike mortgage loans and car loans, do not disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment.[10]

Credit card issuers earn about 75% of their revenues from the interest paid by borrowers who do not pay in full each month. Several companies have instituted charges or even canceled credit cards for customers who pay in full each month, preferring customers with large credit balances who pay minimum monthly payments.[11]

As bankruptcy levels have risen, total credit card profitability has grown--credit card lending is now twice as profitable as all other lending activities. In the third quarter of 1997, credit card banks showed a 2.59% return on assets, compared to a 1.22% return on assets reported by all commercial banks [12]

Industry consultants estimate that credit card companies could cut their bankruptcy losses by more than 50% if they would institute minimal credit screening.[13]

Some institutions now invest in bad credit card debt. For example, Commercial Financial Services acquires credit card debt that has been charged off as uncollectible from 25 of the largest credit card issuers, packages the debt into securities which it sells to investors, then pursues new collection activities against the customers. CFS securitized $1 billion in charged-off credit cards in 1997, and plans to securitize $1.5 billion this year.[14]

The FDIC observes that by marketing high-risk debt to customers who are at substantial risk for non-payment, credit card issuers have contributed to the rise in consumer bankruptcies.[15]

Subprime lending targets borrowers with poor credit records. Such lending has become the fastest growing, most-profitable subset of consumer lending. Although losses are substantial, interest rates of 18 to 40% on credit card debt make this lending profitable. In the subprime automobile finance market, by charging interest rates of 15% to 25% on secured car loans, several lenders have reported profit margins ranging from 23% to 41%.[16]

On May 2, 1997, the FDIC issued warnings to banks about the risks posed by increased subprime lending. Some industry analysts predict that overall loan default rates will double by the year 2001 and thus warn that "by lowering their credit standards and saturating the market with loans, many banks will be unable to avoid potentially enormous delinquencies and write-offs."[17]

Subprime lending is growing even among reputable lenders. Senator Lauch Faircloth, who notes that he "abhors . . . constraints on the private sector," recently stated about the subprime market: "We have very reputable, very fine institutions, spinning off subsidiaries to get into what I would consider very precarious, reckless, bordering on sleazebag lending."[18]

Home mortgage loans with high loan-to-value ratios, particularly so-called 125% loans, are the major component of the recent surge in home equity lending, both in the prime and subprime markets. Recent growth in the volume of 125% loans has been unprecedented: 1995--$1 billion; 1996--$4 billion; 1997--$10 billion; 1998--an estimated $20 billion. Although such loans are at least partially secured by the debtors' homes and can result in the loss of the home, they carry interest rates much closer to those of credit cards, reportedly in the 13-15% range.[19]

Banks actively solicit debtors for new credit after they file for bankruptcy. Industry analysis explain that these debtors are attractive because they have shown they will take on credit and, by law, they cannot seek a bankruptcy discharge for another six years.[20]

Endnotes

1.Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-offs, and the Personal Bankruptcy Rate*, Bank Trends 98-05 (Division of Insurance, FDIC February 1998); Lawrence Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 Am. Bankr. L.J. 249 (1997); Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, before the Subcommittee on Administrative oversight and the Courts, Committee on the Judiciary, United States Senate, p. 4 (April 1997); Jagdeep S. Bhandari & Lawrence Weiss, *The Increasing Bankruptcy Filing Rate; A Historical Analysis*, National Conference of Bankruptcy Judges (Winter 1993).

2.*E.g.*, Ellis, *Consumer Interest Rate Deregulation*, *supra* note 1, at 5 ("Unfettered by any legal limitation on the income they could earn, lenders began to increase the depth of the market by looking for customers further down the spectrum of credit quality"). In 1978, the Supreme Court permitted banks to "export" the interest rate of its home state in its lending activities. *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978). When some states raised their interest rate caps, the entire consumer credit market was effectively free of all usury laws. The FDIC explains that after the *Marquette* decision, "Some states quickly seized the opportunity to deregulate interest and other banking functions to attract banks and other consumer lenders. . . . [M]ost leading banking states had relaxed or repealed their interest rate ceilings by 1982, and the bank credit market was functionally deregulated." FDIC, *Interest Rate Deregulation*, *supra* note 1 at 3.

3.Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances, Federal Reserve Bulletin 17 (January 1997).

4.OCC Advisory Letter 96-7, September 26, 1996, (96-7.txt at www.occ.treas.gov); FDIC Quarterly Banking Profile Graph Book, Fourth Quarter 1997.

5.Federal Reserve Bulletin, Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances, Table 14 Aggregate and median ratios of debt payments to family incomes, and shares of debtors with ratios above 40 percent and those with any payment sixty days or more past due, by selected family characteristics, 1989, 1992, and 1995; Peter Yoo, *Charging up a Mountain of Debt: Accounting for the Growth of Credit Card Debt*, Review: Federal Reserve Bank of St. Louis, p. 4 (March/April 1997); David Wyss, DRI/McGraw-Hill, "Surveillance Programs & Performance" p. 8 (April 15, 1997).

6.Estimates from 1996 Statistical Abstract, Table 793, Credit Cards--Holders, Numbers, Spending, and Debt, 1990 and 1994, and Projections, 2000; 1996 Statistical Abstract, Table 66, Households, Families, Subfamilies, Married Couples, and Unrelated Individuals 1960-1995.

7.George M. Salem and Aaron C. Clark, GKM Banking Industry Report, Bank Credit Cards: Loan Loss Risks are Growing p. 5 (June 11, 1996). They express their estimate per adult

Americans, but it is possible to convert to households to keep the analysis parallel.

8.*Solicitations Reach 3 Billion, but Response Falls*, Credit Card News (April 1, 1998)

9.Report of the National Bankruptcy Review Commission 93 (October 20, 1997); George M. Salem and Aaron C. Clark, GKM Banking Industry Report, Bank Credit Cards: Loan Loss Risks are Growing, p. 9 (June 11, 1996). The Bankruptcy Review Commission received an advertisement for a two-day workshop for creditors entitled "Competing in the Sub Prime Credit Card Market," including a presentation entitled "Targeting College Students: Real Life 101," with tips on how to "target the money makers of tomorrow."

10.George M. Salem and Aaron C. Clark, GKM Banking Industry Report, Bank Credit Cards: Loan Loss Risks are Growing, p. 25 (June 11, 1996).

11.David S. Evans & Richard L. Schmalensee, The Economics of the Payment Card Industry Fig. 3 (1993); Beneficial National Bank of Delaware canceled the Mastercards for 12,000 customers who pay their bills in full; they are expected to cancel another 30,000 customers soon. Other lenders, such as NationsBank and GE Rewards MasterCard have imposed fees or canceled cards for customers who pay their bills in full. Bruce Mohl, *The careful debtor loses credit at BJ's*, The Boston Globe A1, col.1 (September 25, 1997).

12.Federal Reserve Board, *The Profitability of Credit Card Operations of Depository Institutions* (August 1997); Ausubel, *Credit Card Profits, supra* note 1.

13.Fair, Isaac & Co. released a new bankruptcy predictor that it says can eliminate 54% of bankruptcy losses by screening potential nonpayers from the bottom 10% of credit card holders. Fair, Isaac & Co. @ www.fairisaac.com; *Credit Cards: Fight for Bankruptcy Law Reform Masks Truth*, 162 Am. Banker 30 (September 8, 1997).

14.See OCC Comptroller's Handbook on Credit Card Lending, at 44-48 (September 1996); CFS Stays Private While Getting Bigger, Private Placement Report, January 12, 1998, 1, 1998 WL 5034591.

15.*E.g.*, Ellis, *Consumer Interest Rate Deregulation, supra* note 1, at 5-6 ("The dismantling of usury laws opened wide the doors to new markets for credit card lenders. . . [W]hen interest rates were deregulated, less credit rationing occurred and higher-risk borrowers were allowed into the market. . . . [I]nterest rate deregulation altered the credit markets and led to a substantial expansion in credit availability, which has led to an increase in the level of borrower credit problems, including personal bankruptcy.").

16.Dow Jones & Company, Inc. Capital Markets Report (Oct. 7, 1997) (noting an increase from $80 billion in subprime loans in 1992 to $150 billion in 1996); Robyn Meredith, *Will Ford Become the New Repo Man?*, N.Y. TIMES, Dec. 15, 1996, at A1; Life After Mercury: How to Pick a 'Safe' Used-Car Lender, Financial World, May 20, 1997, 40.

17. Tom Neagle, manager, Financial Institutions Group of A.T. Kearney, Chicago-based management consulting firm, quoted in *Give me your delinquents, your former bankrupts, yearning to borrow* . . ., 88 ABA BANKING J. 31, 63 (August 1996) (discussing consulting firm study); Barbara Rehm, *In a First, FDIC Warns Banks About Dangers of Subprime Lending*, 162 American Banker 2 (May 13, 1997).

18. Senator Raises Concerns About High LTV Lending, National Mortgage News, November 3, 1997, 1997 WL 12863625; Subprime Boom Makes Partners of Traditional Foes, American Banker, October 2, 1997, 1997 WL 13706004; Banc One Sitting on Gain from B & C Stock, National Mortgage News, August 4, 1997, 1997 WL 12862903.

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20. Dr. Michael Staten, Director, Credit Research Center, Krannert School of Management, Purdue University, *Working Paper No. 58 The Impact of Post-Bankruptcy Credit on the Number of Personal Bankruptcies* (January 1993).

Bankruptcy

THE WHITE HOUSE

WASHINGTON

June 18, 1998

MEMORANDUM TO THE PRESIDENT

FROM: **GENE SPERLING**
SALLY KATZEN

RE: **BANKRUPTCY REFORM LEGISLATION**

Last week, the House passed, by a veto-proof majority, a bankruptcy bill despite an Administration statement of strong opposition. A better, but still flawed, bill (voted out of committee 16-2) may be taken up by the Senate before the July 4th recess or soon thereafter. Both bills were changed recently to address concerns that you, the First Lady, and others have raised about their impact on debtors' capacity to pay child support and alimony, although some problems still remain.

After an NEC interagency review, your advisors have reached a consensus that some bankruptcy reform is important. These bills contain many provisions that are beneficial, including a cap on state homestead exemptions, debtor education pilots, penalties for unjustified creditor activities, measures to discourage bad-faith repeat filings, and provisions to improve data collection and audit procedures. However, certain controversial provisions of the current bills need significant changes to satisfy our objectives and concerns. **We propose to advance quickly an Administration proposal in hopes of influencing the Senate bill on the floor and giving the Administration greater leverage in conference.** The proposal would address three issues: (1) limitations on access to Chapter 7; (2) new nondischargeable debts and their impact on child support and alimony payments; and (3) new provisions to protect against coercive creditor behavior and to require more responsibility from creditors in extending credit. The group also has identified alternatives to parts of this proposal on which we could compromise, if necessary.

I. BACKGROUND

Rising Consumer Bankruptcies: Despite what Goldman Sachs recently called "the best economy ever," personal bankruptcies have continued to rise sharply, from roughly 800,000 in 1994 to nearly 1.4 million in 1997. Recent figures for the first quarter of 1998 showed another

20 percent increase over 1997's pace.

Disputed Causes: There is much dispute about the cause of this increase, but little definitive evidence. Creditors assert that lawyer advertising, reduced social stigma, and increased information about the financial advantages of bankruptcy have encouraged an increasing number of consumers to walk away from debts they could repay. Consumer advocates argue that lenders have irresponsibly extended too much credit to families who are ill-prepared to handle it, and that most bankruptcies happen when unexpected events push such a family over the financial edge; indeed, rising bankruptcy rates track closely rising levels of unsecured debt, although debt burdens have actually dropped due to lower interest rates.

Potential for Abuse: Under current rules, some debtors with high incomes walk away from their debts entirely, even when they have the capacity to repay at least a portion of those debts; other debtors file repeatedly without any intention of completing bankruptcy, for the purpose of delaying bona fide collection activities; and generous state exemptions (including unlimited homestead exemptions in eight states and exemptions for items like race horses and silver spoons in Virginia) prompt some to shift assets to exempt categories prior to a bankruptcy filing to avoid making payment to any unsecured creditors. Consumer advocates argue that these cases are not the norm and should not prompt limits on those who genuinely need bankruptcy's fresh start.

Consumer Impact: Regardless of who is to blame, **higher levels of debt charge-offs appear to raise the cost of credit for everyone.** One industry study suggests that bankruptcies cost every American household between $300-400 per year. Higher credit costs disproportionately fall on lower-income families, since they are more likely to carry a balance on their cards. While in the past credit card interest rates did not always rise and fall with market rates, the industry is now more competitive, so that many believe that, over the long run, reduced bankruptcies are likely to translate to lower interest rates and increased access to credit for those who pay their bills.

Legislative Momentum: The popularity of these bills can be explained by the system's vulnerability to abuse and the apparent consumer costs, as well as an extremely effective and well-financed industry campaign and legislators' fears of being labeled protectors of deadbeats.

II. LIMITATIONS ON ACCESS TO CHAPTER 7 BANKRUPTCY

Current Law: Today, there is little limit on debtors' access to Chapter 7's full and immediate discharge of debt (with virtually no payments to unsecured creditors); however, in some circuits, courts find, on their own motion, that it is "substantial abuse" for a debtor with the ability to repay 20% of their unsecured debts over three years, after taking account of all necessary expenses, to go through Chapter 7 rather than a Chapter 13 repayment plan,

House and Senate Bills: Both bills would require those with the capacity to repay a portion of their debt to do so under a Chapter 13 plan. We opposed the <u>House bill</u> because it determines access to Chapter 7 under a rigid "means test" that does not take into account the unique circumstances of individual debtors. The Senate approach is more flexible, building on the abuse test in use in some circuits. The Senate bill would authorize a bankruptcy judge to apply this test to any debtor with income above the median and, for the first time, allow creditors to file the motion seeking a determination of abuse. Creditors would have to pay debtors' attorneys fees, if their filings were not 'substantially justified' or were brought to coerce a debtor to waive a right.

Administration proposal: We propose a variation on the Senate bill whereby **the bankruptcy court would have discretion to determine whether or not a debtor's use of Chapter 7 is abuse; however, there would be a presumption of abuse if a debtor has an income above the median and the capacity to repay either at least 30% of her unsecured, nonpriority debts or some specified amount (such as $5000) over three years.** (No debtor would be denied access to Chapter 7 unless she had the ability to repay at least $50 a month in unsecured, nonpriority debt. Any lesser amount is too small to merit the Chapter 13 administrative costs or to risk the chance that the creditor was pursuing the motion to coerce the debtor to forgo another bankruptcy right.) We also would provide that, if a debtor moved more than $50,000 from nonexempt to exempt assets within one year of the filing, she would be subject to a presumption of abuse, regardless of income. In determining a debtor's capacity to repay, we propose to explicitly exclude luxuries (e.g., expensive cars or boats) from necessary expenses.

These presumptive guidelines could be overcome if the court determined, e.g., that the debtor faced unusual but necessary expenses or could not be expected to maintain reliably her current level of income. Such presumptive guidelines have proven to be highly effective in promoting uniformity and fairness in establishing child support award amounts. Since the average debtor under Chapter 13 repays 20% of her debts and has income below the national median, those who meet this higher threshold are the most likely to succeed under a repayment plan.

III. NONDISCHARGEABLE DEBT AND ITS IMPACT ON CHILD SUPPORT AND ALIMONY

The Bankruptcy Code makes debts nondischargeable only where there is an overriding public purpose, as with child support, alimony, educational loans, tax obligations, or debts incurred by fraud. To address growing concerns about gaming of the system, both bills broaden the categories of nondischargeable credit card debt, although the largest new category was dropped and the remaining two narrowed. Moreover, as consumers use credit cards for new purposes (e.g., groceries or paying student loans), additional credit card debts become dischargeable. This Administration envisions -- in fact, encourages -- greater use of electronic commerce, so we do not want bankruptcy discharge rules that discourage credit card companies from providing new opportunities for consumers to have the convenience of credit card payment. However, the provisions in these bills creating new nondischargeable debts raise two questions: (1) Do the additional debts made nondischargeable rise to the same level of public priority as other nondischargeable debts? and (2) What impact does the protection of new categories of debt have on the ability of the debtor, post-bankruptcy, to repay existing nondischargeable debts?

Debts incurred to pay other nondischargeable debts.

Current law: A credit card debt incurred to pay federal taxes is nondischargeable, to prevent "gaming" by paying off nondischargeable debts with a credit card which will be discharged.

House and Senate bills: Both make a debt incurred to pay any nondischargeable debt nondischargeable, although the Senate effectively eliminates the provision if the debtor is a single parent or owes child support and/or alimony.

Administration Proposal: We propose that the **current law remain unchanged**; however, if a debtor paid a nondischargeable debt with a credit card, it would be a factor in determining whether the debtor's use of Chapter 7 was abuse.

Debts incurred in the period immediately before bankruptcy.

Current Law: Debts for luxuries over $1000 owed to a single creditor within 60 days of bankruptcy are nondischargeable. There is evidence that this and other anti-fraud provisions do not prevent some debtors from taking the opportunity to run up debt before filing bankruptcy.

House and Senate Bills: Both would make all debts incurred within 90 days of bankruptcy for luxuries presumptively nondischargeable. In addition, they would make presumptively nondischargeable debt above ($250 in the House; $400 in the Senate) per credit card for necessaries during the same period.

Administration Proposal: We propose to agree to make **debt for luxuries within 90 days of bankruptcy presumptively nondischargeable; however, a cap of $250 or $400 on necessary expenses incurred prior to bankruptcy is inappropriate.** One can easily imagine a family, in the months prior to bankruptcy, paying for rent, school clothes, and even groceries on their credit card. Courts can easily compare current spending patterns to prior spending and determine whether charges are truly for necessary expenses.

Child Support and Alimony Considerations

The bills have seven new provisions designed to either mitigate the impact of the new nondischargeable debt on child support and alimony or to give child support and alimony additional protections in and after bankruptcy. Some experts argue that the benefits provided by these additional provisions outweigh any modest harm to child support and alimony payments that remains from the nondischargeability provisions. Moreover, if needs-based reform is done right and shifts only those with the capacity to repay, as we propose, it will likely enhance the collection of these payments, as debts in Chapter 13 are repaid under the supervision of the bankruptcy court. On the other hand, the women's groups still oppose these bills, arguing that there is no way to mitigate fully the consequences of the expanded categories of nondischargeable debt, which enhance competition for the debtor's limited funds. Moreover, these provisions, which focus only on child support and alimony, do not address our policy concern that new nondischargeable debt will compete with other existing nondischargeable debts, such as education loans. For these reasons, our proposals would allow only one category of new nondischargeable debt (luxuries purchased 90 days before bankruptcy); for the remaining categories, we propose to leave current law or address the problem a different way.

IV. ADDITIONAL CONSUMER PROTECTIONS AGAINST PREDATORY CREDITOR PRACTICES

Your advisors are particularly concerned about the unequal bargaining power of the creditor and debtor and how the changes in bankruptcy rules could further shift the balance and create opportunities for coercion and harm. To address this concern, and to ensure that legislation requires responsibility of both debtor and creditor, we propose new consumer protections.

Reaffirmations of Unsecured Debt

Although debtors in Chapter 7 have a right to have their unsecured debts discharged, some debtors reaffirm debts. While there may be some circumstances in which reaffirmation is in the debtor's best interest (e.g., as a condition of obtaining credit to keep open a small business), those cases are few. The risk is real, however, that debtors are pressured into reaffirming their debts by aggressive creditors. After Sears recently paid large penalties for such practices, another Bankruptcy Judge (Fenning) said she scrutinized her court records and found evidence of widespread coercive reaffirmations. Since reaffirmed debts survive bankruptcy, they compete with child support and alimony after bankruptcy. Eliminating coercive reaffirmations also would help to reduce the current level of competition child support and alimony payments face.

Current Law: For a reaffirmation to be valid, the creditor must provide required disclosures and the court must determine that the reaffirmation does not impose an undue hardship on the debtor or a dependant and is in the debtor's best interest; however, an affidavit of the debtor's attorney to that effect suffices.

House and Senate Bills: No related provisions.

Administration Proposal: We propose to require that the court itself find that there is a compelling reason for the debtor to reaffirm an unsecured debt, without reliance on counsel affidavits. We also propose to bar reaffirmation of debts that add attorneys' fees and costs to the debt, to increase penalties on attempts to enforce invalid reaffirmations, and to clarify that creditors may not threaten to file motions alleging abuse of Chapter 7 or solicit a reaffirmation after the automatic stay is imposed.

Credit Card Minimum Payment Disclosure

We also believe that some signal should be sent to creditors about lending practices that entice debtors to get further and further into debt.

Current Law: Most debtors believe that by making the minimum payment on their credit card they are slowly working off their debt. However, depending upon the interest rate, they may be falling further and further behind. Creditors are increasingly offering minimum payment plans that amortize debt over decades, if at all.

House and Senate bills: No related provisions.

Administration Proposal: We propose a process for subordinating unsecured, nonpriority debt if the creditor did not disclose clearly to the debtor the time period over which the debt would amortize at the minimum payment level. The subordinated debt would be paid, in Chapter 7 or 13, only after all other unsecured, nonpriority debt. It most cases, this means it will not be repaid.

Other Non-Bankruptcy Steps to Improve Consumer Credit Practices

We also are exploring whether there are other non-bankruptcy steps that we can take to clamp down on predatory lender practices and better help consumers to understand their own borrowing. We have consensus on a proposal that requires all lenders to disclose the time period over which debt is amortized by minimum payments. This proposal, and others under review, fall under the jurisdiction of other committees, so it is not feasible to insist that Congress include these proposals in the bankruptcy bill at this time. However, we might unveil these proposals in connection with a campaign to educate consumers about the use of credit, using the bully pulpit as we have done to encourage retirement savings.

V. ADVISORS' RECOMMENDATIONS

All your advisors recommend we proceed as described, including CoS, NEC, Counsel, OPL, OLA, OMB, CEA, DPC, First Lady, DoJ, Treasury, HHS, Commerce, and Education.

- The NEC believes that requiring greater responsibility of both creditors and debtors is the best way to address the "unclean hands" of some of the legislation's proponents.
- Treasury emphasizes that needs-based reform will decrease the cost of, and increase access to, credit for those debtors who do pay their bills, by limiting opportunistic bankruptcy among those higher income debtors who do not.
- CEA believes nondischargeability provisions should not prevent agreement on a bill which strengthens child support and alimony in other ways, particularly if the nondischargeability provisions are targeted to address 'gaming' of the bankruptcy system.
- DoJ supports the plan and stresses that other provisions of these bills, like the cap on state homestead exemptions, measures to discourage bad faith repeat filings, and provisions to improve data collection and audit procedures, are important reforms.
- OPL believes that, while consumer advocates oppose any bill, reforms limiting access to Chapter 7 and stemming coercive reaffirmations appear valid. OPL wants to see us fight for aspects of our proposal that protect against any impact on child support (before or after bankruptcy) of new nondischargeable credit card debt.
- DPC and the First Lady's Office strongly support advancing proposals that achieve more balanced reform by calling for responsibility on the part of the creditor as well as the debtor, and recommends that we continue to focus on the child support issue to ensure that protections in this area are as strong as possible.
- OLA stresses the popularity of bankruptcy reform and advises that we advance proposals that have a realistic prospect of inclusion, or we may find ourselves faced with overwhelmingly popular legislation that fails to satisfy our announced concerns.

VI. DECISION

____ **PROCEED AS DESCRIBED**

____ **LET'S DISCUSS**

Bankruptcy

Bankruptcy Issue

The NEC is seeking Agency/WH views to incorporate into a memo to the President that lays out a proposal for the Administration to advance to the Congress on bankruptcy reform. The House passed its bill (which we "strongly opposed") by a veto-proof margin, and the Senate version also enjoys wide-spread support in that chamber.

Issues DPC cares about:

- Protect child support and alimony collection.
- Ensure that any Administration alternative is balanced -- i.e., demands responsibility from both the debtors and creditors (many argue that the current bills crack down only on debtor abuse; however, because of Committee jurisdiction issues, the NEC working group has been struggling with this area).

Positive Developments on Child Support -- under pressure from us and others, the House and/or the Senate have agreed to several "sweeteners", including:

- Elevate priority of child support and alimony in bankruptcy distributions under Chapter 7, making it more likely the child support will be paid in the 5 percent of Chapter 7 liquidations that have assets to distribute.
- Make an exception for child support to general rule that bankruptcy creates an automatic stay on liens, (California district attorneys praise this provision because it would make it easier for local agencies that have paid welfare, for example, to recoup their payment from parents that owed child support or alimony).
- Clarify that child support obligations surviving bankruptcy are collectable from exempt assets.
- Require debtor to be current on family obligations before Chapter 13 plan confirmation and discharge.

Also, many experts argue that the "means testing" provisions that would move debtors with a capacity to repay debt from Chapter 7 to Chapter 13 may actually help child support collection, as these debtors would be repaying their debt under a supervised repayment plan.

What the Hill Still Wants to Do that Might Threaten Child Support:

- Put the following debts in potential competition with child support (particularly post-bankruptcy) by making them nondischargeable:
  1. luxury purchases made 90 days before declaring bankruptcy;
  2. necessary purchases above a set amount incurred 90 days before declaring bankruptcy; and
  3. credit card debt incurred to pay nondischargeable debt (i.e., child support, student loans).

NEC Proposal for Administration Alternative:

- Agree to make presumptively nondischargeable all luxury purchases incurred 90 days prior to declaring bankruptcy.
- Advance strong restrictions on reaffirmations, making it harder for credit card companies to coerce people into agreeing to repay debts they don't have to repay, that would compete with child support post-bankruptcy.
- Subordinate debt (i.e., make it a very low priority) of credit card companies that fail to

make clear to consumers how long it would take to pay off their debt by following the "minimum monthly payment" plan.

- Advance our own version of "Needs Based" reform (giving bankruptcy courts significant discretion, but supplying presumptive guidelines for ineligibility for Chapter 7 -- a person with over 100 percent of median income and an ability to repay 30 percent of unsecured debt).

Underlying question for us to answer:

- How do we best preserve our stance of not harming child support as a part of bankruptcy reform? Expanding the categories of nondischargeable debt may endanger child support, particularly post-bankruptcy, and there is no way to eliminate fully that danger. On the other hand, many argue that the new protections for child support in these bills could make reform a net plus for child support collections. However, it is very hard to know whether the pluses of these changes will outweigh the minuses in the real world. The NEC has been sensitive to this point and has determined that this is as far as we can go; still, in the memorandum to the President, we might want to weigh in that we should stand firm (as outlined in the memo) on nondischargeability and not back down in negotiations and allow the provisions to broaden further, putting the President in the position of receiving a bill that is pretty good, but that could be seen as backing away from his on-record promise of protecting child support collection.

Bankruptcy

Diana Fortuna 06/11/98 02:17:39 PM

Record Type: Record

To: Bruce N. Reed/OPD/EOP, Elena Kagan/OPD/EOP

cc: Cynthia A. Rice/OPD/EOP, Andrea Kane/OPD/EOP
Subject: bankruptcy and child support

You asked Andrea if the House bankruptcy legislation satisfied us on the child support issue. It didn't, unfortunately, and we sent up a SAP yesterday opposing the bill that included this issue prominently. They've made some movement, but not enough.

Bruce N. Reed
06/11/98 02:33:36 PM

Record Type: Record

To: Diana Fortuna/OPD/EOP

cc: Elena Kagan/OPD/EOP, Cynthia A. Rice/OPD/EOP, Andrea Kane/OPD/EOP
Subject: Re: bankruptcy and child support

thanks -- that's fine. The President wants to veto the bankruptcy bill, so he won't mind.

Bankruptcy

Impact of Bankruptcy on Credit Card Interest Rates

- For a long time, the credit card industry was not very competitive, profits were high, and credit card interest rates were unresponsive to other interest rates (Ausubel, 1991).

- Over the course of the 1990s, this changed. Most observers now characterize it as an intensely competitive industry where issuers compete in large part by offering consumers lower interest rates. Rates have fallen substantially (chart 1) even as chargeoff losses have risen (chart 2), driving profit rates down sharply: In 1997 the average banking industry Return on Assets (ROA) was 1.94 percent for non-credit-card operations and 2.13 percent for credit card operations.

- In 1997, credit card issuers had to write off over 6 percent of assets as uncollectable, with somewhat less than half of chargeoffs reflecting bankruptcy losses; chargeoffs have been rising sharply in recent years, in parallel with the rising bankruptcy rate.

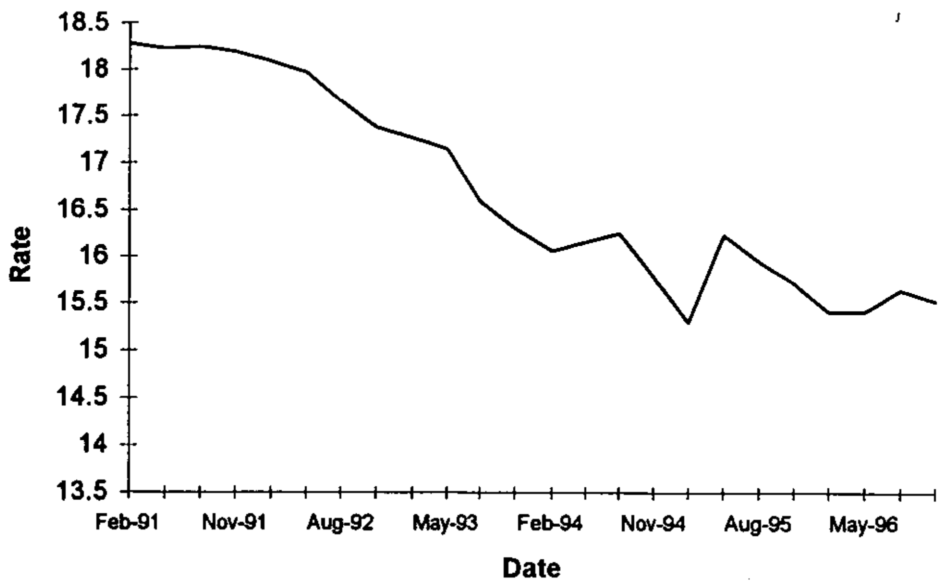
- Industry trade publications have run several articles in the last few years examining the performance of alternative models of bankruptcy risk; the explicitly stated purpose of these models is to help issuers determine bankruptcy risks so that correspondingly higher interest rates can be charged.

- When a private marketing survey asked issuers what were the primary factors in setting interest rates, the ranking was (1) competition; (2) cost of funds; (3) operations costs.

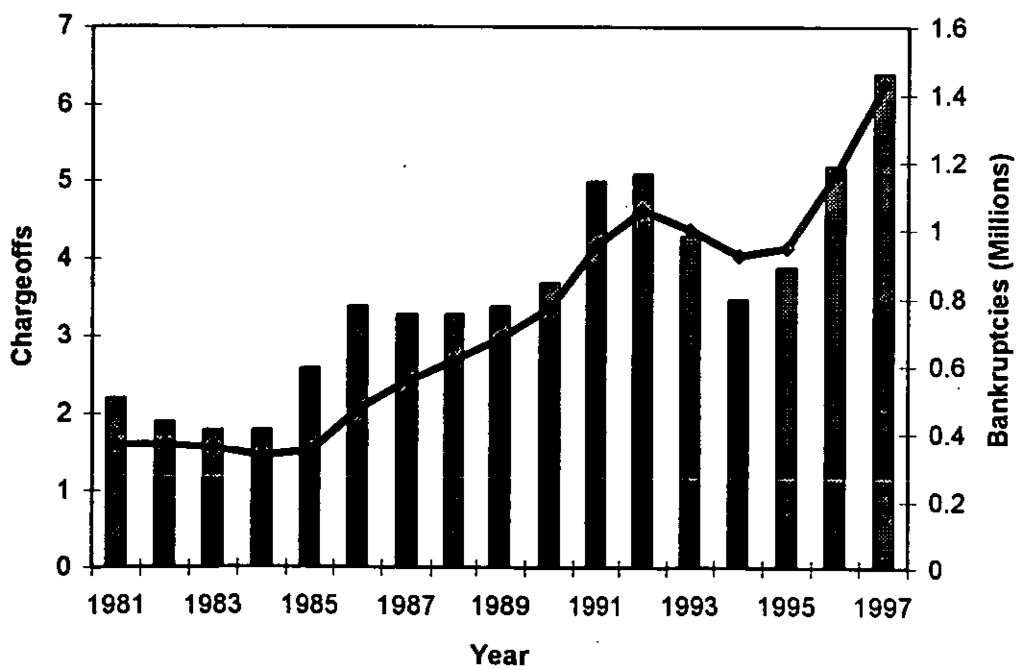
- According to the most recent Federal Reserve annual report to Congress on the credit card industry, "Competition in the credit card market remains intense, with thousands of firms offering bank cards to consumers. Prior to the early 1990s, card issuers competed primarily by waiving annual fees and providing credit card program enhancements. Since then, however, interest-rate competition has played a much more prominent role. Many credit card issuers, including nearly all of the largest issuers, have lowered interest rates on many of their accounts ... Credit card interest rates in general have become more responsive to issuers' costs of funds (currently, about 70 percent of card issuers tie their interest rates directly to an index that moves with market rates). ... Several of the more rapidly growing firms in recent years have attracted market share by offering comparatively low-rate cards. ... credit card interest rates fell sharply from mid-1991 through early 1994 ... The general decline in credit card interest rates from mid-1991 is the result of many factors, including much more pronounced competition based on this aspect of credit card pricing. The decline in rates also reflects, in large measure, the sharp drop in credit card issuers' costs of funds in the early part of this period."

In sum, the largest portion of expenses is chargeoffs (which are heavily related to bankruptcy), profit rates are no longer particularly high, and both trade journals and regulators emphasize competition on interest rates as a driving force in the industry today. It is difficult to avoid the conclusion that a large part of the reason credit card interest rates remain so high is that issuers must cover the losses they incur from bankruptcies of card users.

Average Credit Card Interest Rate



Bankruptcy Rate vs. Chargeoffs



Bankruptcy

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

THE DIRECTOR

May 21, 1998

The Honorable George W. Gekas
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Gekas:

I am writing in response to your letter, dated May 11, 1998, to President Clinton. As the Justice Department noted in its letter to Chairman Hyde, dated May 7, 1998, the President supports bankruptcy reform that requires responsibility of debtors who have the ability to repay a portion of their debts and prevents abuse of the bankruptcy system by all relevant parties. However, the Administration strongly opposes H.R. 3150 in its present form. One provision of the bill would establish a rigid and arbitrary means test to determine whether a debtor could file for bankruptcy under Chapter 7 or would be required to file under Chapter 13 rules. Bankruptcy courts should have greater discretion to consider the specific circumstances of a debtor in bankruptcy.

H.R. 3150 also would make nondischargeable certain credit card debt. The Bankruptcy Code generally makes nondischargeable debts only where there is an overriding public purpose, as with debts for child support and alimony payments, educational loans, tax obligations, or debts incurred by fraud. There has been no sufficient finding that current protections against fraud and debt run-up prior to bankruptcy are ineffective and that the additional debts made nondischargeable by this bill rise to that level of public priority. Moreover, by making these credit card debts nondischargeable, the bill puts them in competition with payments to a former spouse or custodial parent after the debtor leaves bankruptcy, which could diminish the ability of debtors to fulfill their child support and alimony obligations. Amendments made during the Judiciary Committee mark-up are improvements but do not effectively eliminate this problem.

The Administration looks forward to working with the Congress on a balanced package of reforms that addresses these concerns and requires responsibility on the part of both debtors and creditors.

Sincerely,

Jacob J. Lew
Acting Director

IDENTICAL LETTER SENT TO THE HONORABLE BILL MCCOLLUM,
THE HONORABLE JAMES P. MORAN, THE HONORABLE RICK BOUCHER

Bankruptcy

- *Clarify the automatic stay to bar any threats that 707(b) motions will be filed and to bar creditors from soliciting reaffirmations of unsecured debt.* Section 362(a)(6) of the Bankruptcy Code provides that the filing of a petition in bankruptcy operates as stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title." While this provision unambiguously bars a creditors from seeking reaffirmations, some courts have ruled that creditors are free to solicit reaffirmations, as long as the solicitation does not contain "coercive" language. *See* In re Duke, 79 F.3d 43 (7th Cir. 1996). Other courts have gone so far as to allow solicitations that contain "mild warnings." *See* Brown v. Pennsylvania State Employees Credit Union, 851 F.3d 81 (3d Cir. 1988). Some of these courts might hold that letters indicating that the debtor is subject to a 707(b) motion are not violative of the automatic stay. To prevent creditors from using 707(b) motions and other devices coercively, section 362 could be modified to explicitly bar any threat by a creditor that a 707(b) motion will be filed and to bar creditors from soliciting reaffirmations of unsecured debt.

- *Limit further the circumstances under which courts can approve a reaffirmation agreement.* Currently, section 524(c) of the Bankruptcy Code imposes a host of limitations on reaffirmation agreements, including various disclosure requirements. In addition, unless the debtor's agreement to the reaffirmation is evidenced by an affidavit of the debtor's attorney, section 524(c) requires the court to analyze reaffirmation agreements and approve only those agreements in the debtors best interests. Notwithstanding these requirements, a recent Visa survey reported that 52% of debtors surveyed reported reaffirming one or more debts, often including unsecured debts. The National Bankruptcy Review Commission recommended that the requirements of section 524(c) be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm: (i) does not exceed the allowed secured claim; (ii) the lien is not avoidable under the provisions of title 11; (iii) no attorney fees, costs or expenses have been added to the principal amount of the debt to be reaffirmed; and (iv) the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of the lien perfection. This proposal would eliminate reaffirmation of unsecured debt -- this would not preclude debtors from seeking to maintain unsecured credit relationships, but rather would force debtors to go to chapter 13 to work out a repayment plan.

- *Penalize attempts by creditors to seek to enforce invalid reaffirmations.* Sometimes creditors obtain debtor approval of reaffirmations, but do not meet the approval requirements of section 524(c). Often debtors make payments on such reaffirmations unaware that the agreements are unenforceable. The National Bankruptcy Review Commission recommended, and a bill by Congressman Nadler proposes, that a new section 524(k) be added to the Bankruptcy Code. This new subsection would allow an individual who has received a discharge to recover costs and attorneys fees, plus treble damages (at a minimum of $5,000), from a credit to who threatens, files suit, or otherwise seeks to collect any debt that was discharged in bankruptcy and not the subject of a reaffirmation agreement in accordance with section 524.

Bankruptcy

APPENDIX

Evaluating the impact of alternative guidelines - REVISED

The tables below are revised to reflect the fact that, if we retain the current law reliance on a 3-5 year repayment period, it will reduce the impacts of rules which rely on the debtors ability to repay relative to our earlier calculations, which assumed a 5-7 year repayment period. For example, we now find that a rule of 100% of median income and a 20% ability to repay would lead to approximately 10-11% of cases being potentially impacted by presumptive guidelines.

Table 1. Percent of Chapter 7 Filers Potentially Impacted by Gekas-type* Needs Based Provisions With Ability to Repay over 3 Years

Gross Income as a % of National Median	Filers with Monthly Net Income > $50 and Share of Unsecured Nonpriority Debt Repayable over 3 Years			
	> 20%	>30%	> 40%	> 50%
> 100%	9.9	7.9	6.5	5.4
> 110%	8.6	6.9	5.7	4.7
> 125%	6.5	5.2	4.3	3.5

*Calculations from data by Ernst & Young using 1997 VISA national bankruptcy database, debtors' expenses as allowed under HR 3150

Table 2. Percent of Chapter 7 Filers Potentially Impacted by Discretionary* Needs Based Provisions With Ability to Repay over 3 Years

Gross Income as a % of National Median	Filers with Monthly Net Income > $50 and Share of Unsecured Nonpriority Debt Repayable over 3 Years			
	> 20%	>30%	> 40%	> 50%
> 100%	11.3	9.2	7.6	6.3
> 110%	9.6	7.8	6.4	5.3
> 125%	7.0	5.7	4.7	3.9

*Calculations from data by Ernst & Young using 1997 VISA national bankruptcy database, debtors' expenses as reported in bankruptcy petitions

Bankruptcy

THE WHITE HOUSE

Office of the Press Secretary

Embargoed For Release
Until 10:06 A.M. EDT
Saturday, May 9, 1998

RADIO ADDRESS OF THE PRESIDENT TO THE NATION

The Oval Office

THE PRESIDENT: Good morning. Tomorrow is Mother's Day, a special moment to express the gratitude, respect, and love we feel all year round. Our mothers give us life; they offer us unconditional love, strong guidance, and the sense that we can grow up to do anything we can dream of. From our first moments, mothers are our best teachers and most selfless friends. And, like my own mother, whom I miss very much, especially on Mother's Day, they rarely ask for thanks. A mother's main wish is to see her children grow up healthy and happy.

Today, I want to talk about a few ways we, here in Washington, can give all mothers that peace of mind, whether they work in an office, a factory, a hospital, or at home. To make that tribute to motherhood, we must all take responsibility for the care of our children. For many mothers who work, as my mother did, peace of mind requires affordable, quality child care. Millions of American women have full-time jobs outside the home. Three of five mothers with children under six are working to meet their obligations to their children and their employers. Juggling those responsibilities is even more difficult when quality child care is either hard to find or too expensive to afford.

That's why I've included in my balanced budget a significant new investment in child care. I urge Congress to join me in making child care better, safer and more affordable for those who need it.

To help parents find the best care for their children, today I'm releasing a report by the Department of Health and Human Services. It's a consumer guide to child care quality that recommends four steps for parents: One, interview the potential care-givers; two, check the references; three, evaluate how the care-giver meets your child's needs; and four, stay involved. As Mother's Day reminds us, governments don't raise children, parents do. There is no substitute for a mother's love or a parent's responsibility.

We, too, in the national and state governments, however, have a responsibility; a big one is to protect America's children from abuse and neglect. Nothing gives mothers peace of mind like the knowledge their children are in safe hands. Today I'm also releasing a new Justice Department set of guidelines for screening child care workers and other care-givers; and again, I urge Congress to act on a proposal I put forth to facilitate background checks on child care-givers. There is strong bipartisan support for this proposal, and I'm hopeful that members of both parties will move quickly to give America's children the care they deserve.

There is one other thing I'd like to talk about that we must do to protect our children. Fathers must take their share of responsibility, too. Children deserve to be raised by both parents, but when that's not possible, children must still receive the support they need. The unfortunate division of families cannot mean the end of child support. That's why we have worked so hard to toughen enforcement of child support laws; and, since 1992, we've raised collections by 68 percent a year.

We've worked too hard for too long toughening enforcement of child support laws to let our progress be accidentally undone. But that could happen if Congress goes ahead with one part of bankruptcy reform legislation now under consideration. I'm willing to work with Congress to pass responsible and fair bankruptcy reform. However, under one leading proposal, when a father declares personal bankruptcy, a mother may have to compete with powerful banks and credit card companies for the money they're owed. That's not the law now, and if that competition starts we all know who will lose the contest -- our children.

Parents have to step up to their responsibilities, and so does Congress. Some changes to consumer bankruptcy laws are in order, but mothers and children should keep their priority under the child support laws. They shouldn't have to stand in line for the support they need.

America's mothers hold a special place in our hearts. In return, we owe them the love and respect they have given us. On Mother's Day, we do so with cards, bouquets, and gifts. But today and every other day, we should also do everything in our power to give our mothers the peace of mind they deeply deserve.

Thanks for listening.

END

Bankruptcy

Talking It Over

By Hillary Rodham Clinton

Bankruptcy shouldn't let parents off the hook

Over the past weeks, I've learned about proposed bankruptcy-reform legislation in the House of Representatives that could undermine the ability of some parents to collect child support. I have no quarrel with responsible bankruptcy reform, but I do quarrel with aspects of the bill that would force single parents to compete for their child support payments with big banks trying to collect credit card debt. The welfare of our children must come first.

Let me tell you about a hypothetical family: Jan and Simon have three children, ages 1, 3 and 5. Simon is the manager of a small shoe store with an annual salary of $33,000. Jan is a full-time homemaker.

Sadly, they divorce, and Simon agrees to pay child support. Unfortunately, within a year, he's involved in a serious car accident and loses his job. Jan, struggling to raise their three children, stops receiving child support checks. Unable to find work, and behind on his bills, Simon files for bankruptcy protection. Jan is just one of his creditors.

Under current bankruptcy law, Simon is obligated to pay his taxes, his student loans and his child support and alimony. But under the legislation being considered by the House, certain of his credit card debts would also be mandatory. In Simon's case, as parties vie in the fierce competition for limited funds, child support payments and credit card obligations would be pitted against each other.

Unfortunately, Jan and Simon's story is all too common. This year alone, 1.4 million families will file for protection from unmanageable consumer debt under our bankruptcy laws. This represents an increase of about 400 percent since 1980. While some reform is in order, any accompanying threat to child support and alimony payments is not.

This administration has worked too long and too hard to improve child support collection to see it now threatened. The president has cracked down on nonpaying parents and strengthened enforcement. Since 1992, collections are up 68 percent.

Today, families that file under Chapter 7 are relieved of certain debts, but as in Simon's case, they must still repay others, including taxes, educational loans and family and child support obligations. Many also try to continue making home mortgage and car payments. They leave court relieved of some debt but certainly not debt-free.

The aspects of the House bill that concern me would elevate certain types of credit card debt to the same high priority as taxes, school loans and family support. The challenge for Congress is to pass a law that is balanced and fair to both the creditor and the debtor — protecting families and children while reducing abuse of the bankruptcy laws.

The challenge for our economy is to preserve access to credit while making sure that eligible consumers are educated, responsible and protected from unscrupulous practices. It wasn't too long ago that large segments of our society were denied credit. At the time, it was important to provide people with this valuable economic tool, but now, as we all know, credit is readily available.

How many times in the past few months has your phone rung during dinner? You excuse yourself, leave the table and pick up the receiver, only to be greeted by a cheery voice on the other end of the line happily offering you a "pre-approved credit card." Or how many times have you seen or heard advertisements encouraging people with bad credit to borrow more?

For many people in financial straits — for whatever reason — such offers may sound too good to be true. Unfortunately, down the line, too many people find they didn't comprehend how much they would owe and don't have the means to repay the additional debt.

The average bankruptcy filer in this country earns less than $18,000 a year after taxes. And, now, credit card companies even target college and high school students.

Most people use their credit cards responsibly and pay their bills reliably. But, for many Americans — like Jan and Simon — the difference between fiscal security and financial ruin is just one calamity away. A divorce, a lost job, an accident or a child's illness can rob a family of its financial security and eventually lead to bankruptcy court.

As members of Congress grapple with bankruptcy reform, they must deal with the problems that face both creditors and debtors. But one issue is clear. Any effort to reform the bankruptcy system must protect the obligations of parents to support their children.

• *To find out more about Hillary Rodham Clinton and read her past columns, visit the Creators Syndicate World Wide Web page (www.creators.com).*

The Washington Times ★ THURSDAY, MAY 7, 1998

Bankruptcy

Date: 05/12/98 Time: 17:13
With first lady sounding alarm, House panel drafting bankruptcy

WASHINGTON (AP) With Hillary Rodham Clinton warning that it could harm children of single parents, the House Judiciary Committee on Tuesday prepared to draft far-reaching legislation to rewrite the nation's bankruptcy laws.

Rep. Bill McCollum, R-Fla., told the committee the House bill was ``pro-family" because it would help people with good credit records by cracking down on debtor abuse and thereby lowering interest rates for credit cards.

But Rep. Jerrold Nadler, D-N.Y., said the measure would result in ``ruined lives, lost homes, broken families."

As the legislation moves through the House and Senate, some Democrats, consumer and labor groups are trying to slow the process. They are calling attention to a provision that, they contend, would make thousands of mothers and children owed support take a back seat to credit card companies in collecting debts from fathers who file for bankruptcy protection.

The provision ``is a killer part of this bill," Sen. Christopher Dodd, D-Conn., told a news conference.

Dodd and 30 other senators, mostly Democrats, have written Senate Judiciary Committee Chairman Orrin Hatch, R-Utah, expressing concern. Also signing the letter were Republican Sens. James Jeffords of Vermont, Alfonse D'Amato of New York and John Chafee of Rhode Island.

While the bankruptcy laws need to be revised, they wrote, the legislation in its current form would have ``a strong and disproportionate effect" on single parents and their children by putting certain types of credit card debt on the same level of priority as child support and alimony payments.

Hatch has not yet commented on the letter. The Senate Judiciary Committee is scheduled to draft its version of the legislation on Thursday.

Mrs. Clinton, in her column last week in the Washington Times newspaper, said she had no quarrel with ``responsible" bankruptcy overhaul legislation.

``But I do quarrel with aspects of the bill that would force single parents to compete for their child-support payments with big banks trying to collect credit card debt," she wrote. ``The welfare of our children must come first."

President Clinton reprised the idea in his weekly radio address Saturday on a Mother's Day theme, saying some changes to bankruptcy laws are in order, but ``mothers and children should keep their priority."

As they grapple with bankruptcy legislation, lawmakers are alarmed by the rising number of debtors in a strong economy. The number of Americans filing personal bankruptcies last year jumped to 1.2 million up more than 300 percent since 1980 intensifying criticism that people take court protection from creditors too lightly.

Of those 1.2 million cases, some 300,000 involved court orders for child and spousal support, according to Dodd.

Under the House and Senate bills, credit card debt incurred 90 days before an individual files for bankruptcy would be considered nondischargeable, meaning it couldn't be erased or written down. Child support and alimony, federal taxes and student loan debts are nondischargeable under current law.

The Democrats contend that would hurt children because nondischargeable debts are considered the most important to pay and usually get paid first, forcing single mothers to compete for payment with credit card companies.

But Rep. George Gekas, R-Pa., chief sponsor of the House measure, disputed that, saying child support would continue to have a higher priority.

``Child support and alimony are priority debts," he said. ``If you are keeping score, that is children one, creditors nothing."

A coalition of banking industry groups and credit card companies said recently they would be willing to accept a provision that would explicitly establish the priority of child-support payments.

But Jeffords said Tuesday that would not be sufficient, since big commercial creditors ``have so many more weapons and ways they can dun people" for payments.

In another area, Gekas' bill would establish a ``needs" test to determine how much debt relief people should receive and how much they are able to repay a provision to which many Democrats and some Republican senators have objected.

The Senate measure proposed by Sens. Charles Grassley, R-Iowa, and Richard Durbin, D-Ill., seeks to prevent people who can afford to pay their debts from escaping them. But it also includes tough new fines for abuse by creditors who try to intimidate or harass consumers into giving up their legal protections.

APNP-05-12-98 1714EDT

Bankruptcy

Consumer Bankruptcy: Discussion Draft of Proposed Administration Approach
April 23, 1998

There is great controversy over the cause of the rapid increase in bankruptcies; it seems likely that the increase results from a variety of causes. The lack of definitive information and analysis cautions against a radical departure from our historic Bankruptcy system or taking steps whose consequences cannot be predicted with confidence. Nonetheless, the growing number of filings, examples of abuse of Chapter 7 and state exemptions, and evidence of imprudent extensions of credit warrant some appropriate changes to the consumer bankruptcy laws. The Administration believes there is merit in going forward with a package that included four pieces.

1. **A discretionary approach to needs-based bankruptcy**

- Modify Section 707(b) by changing "substantial abuse" to "abuse"
- Provide factors to <u>consider</u> in determining whether abuse is present to include:
  - whether the debtor's income is less than a certain level (to be determined) suggesting no abuse or exceeds a certain level (to be determined) counseling further scrutiny of whether there is abuse
  - the debtor has and is expected to have sufficient disposable income" defined as the ability to pay a reasonable percentage (to be determined) of their unsecured, nonpriority debts over a reasonable period (to be determined)
  - the movement of more than $50,000 into exempt assets within one year of the bankruptcy filing
  - other factors from existing body of law
- [Give creditors standing to file a 707(b) complaint against borrowers whose incomes are above some level (to be determined), sufficient that there is a great enough likelihood of meaningful recovery to outweigh the danger that the motion was brought for the purposes of coercing the debtor to waive a right; but authorize a court to hold a creditor liable for the debtor's costs and damages in defending the 707(b) motion unless the creditor's position in filing the motion was "substantially justified"]

2. **Limitations on abusive use of state exemptions**

- Prohibit the use of state or local exemptions to shield more than $100,000 of real or personal property (other than a family farm)

3. **Disallowance of bankruptcy claims for abusive extensions of credit**

- Disallow claims in bankruptcy if the repayment terms (e.g., minimum payment) would not amortize the debt over a 15-year period (applicable only to debt incurred after passage of the act)

4. Protections to ensure there is no adverse impact on payment of child support

In addition, the Administration will develop a strategy to educate consumers about the dangers of (1) excessive debt accumulation and (2) the implications of making minimum payments on the amortization period of debt. The strategy could include legislation to require disclosure of the amortization period associated with minimum payments.

Bankruptcy

AGENDA FOR BANKRUPTCY MEETING
April 22, 1998

I. Legislative update

II. Discussion of background memo

III. Discretionary (Grassley-Durbin) vs. non-discretionary (Gekas) approach to needs-based

A. Impact on bankruptcy filings
B. Administrative costs
C. Interest group positions

IV. Tactics and strategy

A. Administration (EBB, Sperling, or Raines) letter
B. Justice letter
C. Testimony

V. Next steps

PERSONAL BANKRUPTCY REFORM: A BRIEF SUMMARY
April 21, 1998

Personal bankruptcies have risen substantially over the past two decades, stimulating much interest in reform of the bankruptcy system and several recent proposals on the Hill. But reforms are controversial, reflecting sharp disagreements over the cause of the recent run-up in filings and the difficult balance between creditor and debtor interests. Credit card companies, for example, argue that consumers are increasingly abusing the bankruptcy system, and they therefore advocate a new "needs-based" approach to bankruptcy, which would force some of those who can afford to repay a share of their debts to do so. Such proposals are sharply criticized by consumer groups, who blame the recent increase in bankruptcies on excessive credit extension. The consumer groups offer competing proposals, perhaps as a defensive measure, that would not allow collection of certain debts in bankruptcy if the credit were imprudently extended.

Background on the Bankruptcy Code

Federal bankruptcy law -- originally authorized by Article I, Section 8 of the Constitution -- covers both businesses and individuals. Two chapters of the U.S. Bankruptcy Code, chapter 7 and chapter 13, are particularly relevant to personal bankruptcy:

- **Chapter 7** covers conventional bankruptcy -- liquidation of unsecured assets beyond specified exemption levels, in exchange for a discharge of debts. Under Chapter 7, the bankrupt's estate, excluding any exempted assets, is liquidated and the proceeds are distributed to creditors. In return, the debtor is discharged from most of her debts and retains the right to her future assets, including future income, free from the past claims of creditors. It is worth noting that most bankruptcy filers have no assets beyond those dedicated to secured creditors and those exempt from the bankruptcy estate, so the vast majority of Chapter 7 filers -- well over 90 percent -- are discharged without making any distributions to unsecured creditors. These are known as "no asset" Chapter 7 cases.

- **Chapter 13** provides for "wage-earner" plans that involve partial repayment of debts over three to five years while assets are temporarily protected from creditors. If the repayment plan is successfully completed, remaining debts are discharged.

Debtors can currently choose whether they want to file under chapter 7 or chapter 13; the only limitation on access to chapter 7 is a poorly defined "substantial abuse" test under Section 707(b), which is discussed below. Relative to filing under Chapter 7, the attractions of Chapter 13 are greater asset retention, "super-discharge" of a wider array of types of debts (e.g., debts incurred by fraud), and additional protection for those in arrears on home mortgages. These benefits have proven weak compared to the immediate discharge in Chapter 7. In recent years, roughly two-thirds of personal bankruptcies have been filed under Chapter 7.

Two other aspects of the bankruptcy law are worth highlighting:

- **Exemptions:** In adopting the modern Bankruptcy Code in 1978, Congress chose not to exercise its Constitutional authority to establish a uniform set of bankruptcy exemptions; instead, it authorized debtors to make an election between Federal or state exemptions and authorized states to deny debtors the choice of electing the Federal exemptions. A significant majority of the states have used that authority. Federal exemptions, when available, include the debtor's interest (not to exceed $15,000) in the debtor's residence and the debtor's interest (not to exceed $2,400) in a motor vehicle.

  State exemptions vary substantially. Seven states have unlimited homestead exemptions, while three states and DC have none (although debtors can choose to use the Federal exemptions). High exemption levels increase the attractiveness of Chapter 7 and have produced notorious cases in which the once-rich shelter assets by establishing million dollar homesteads in Florida or Texas before filing bankruptcy under Chapter 7. (Bowie Kuhn and Harvey Meyerson are famous examples.)

- **Limitations on Access to Chapter 7 – Substantial Abuse:** As mentioned above, the only bar to filing under Section 7 is a poorly defined "substantial abuse" test. Under Section 707(b), a bankruptcy petition under Chapter 7 can be dismissed, upon the motion of the Court or the U.S. Trustee, if granting Chapter 7 would be a "substantial abuse." The statute provides, however, for a presumption in favor of granting the debtor's request for relief. Jurisprudence under Section 707(b) varies widely from circuit to circuit. For example, the Eighth and Ninth Circuit Courts of Appeals have held that ability to pay a significant percentage of debt out of future income is grounds for substantial abuse. The Sixth and Fourth Circuits have held that a debtor's ability to repay a substantial percentage of debt, in itself, is not sufficient grounds for finding substantial abuse.

Recent Growth in Personal Bankruptcies and the National Bankruptcy Review Commission

Personal bankruptcies have risen sharply over the past fifteen years, from roughly 300,000 per year in the early 1980s to nearly 1.4 million in 1997. Despite what Goldman Sachs recently called "the best economy ever," consumer bankruptcy filings have grown at least as rapidly as before. After a spike in 1991-1992 to a high of 900,874, and a small drop in 1993 and 1994 to 780,455, consumer bankruptcies have grown annually to 874,462 in 1995, 1,125,006 in 1996, and 1,350,118 in 1997.[1]

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[1] According to Professor Elizabeth Warren of Harvard Law School, small business bankruptcies account for roughly 20 percent of these "consumer" bankruptcies -- although there is no evidence that the 20 percent share has changed much over time, and thus changes in small business bankruptcy behavior can not account for the increase in consumer bankruptcies.

Partially in response to the dramatic increase in personal bankruptcies, Congress created the National Bankruptcy Review Commission in 1994, and charged it with reviewing and updating the bankruptcy code. The Commission held more than 20 Commission meetings, including five regional hearings, with more than 2,400 people in attendance altogether. The nine Commissioners achieved unanimity on a broad series of recommendations -- for example, changing the bankruptcy appellate structure, improving the compilation and dissemination of bankruptcy data, and reforming bankruptcy procedure and jurisdiction -- but were not able to reach consensus in a series of controversial consumer bankruptcy proposals. Instead, the commission was forced to adopted "majority" views on consumer bankruptcy. Those views are discussed below.

Cause of increase in bankruptcies

The cause of the recent increases in personal bankruptcy filings remains controversial. Such controversy is compounded by the paucity of data on bankruptcies. As the National Bankruptcy Review Commission noted, "the Commission struggled with this question but never reached a resolution."

One school of thought points to the role of consumer credit in causing bankruptcies. This view, which is championed by Elizabeth Warren of Harvard Law, Larry Ausubel of the University of Maryland, and Kim Kowalewski of the CBO, notes that consumer debt has risen closely in line with consumer bankruptcies. As Ausubel notes, "Since 1984, the bankruptcy rate has generally moved in tandem with the household debt burden...The social problem is not so much the rise in personal bankruptcies as the rise in overextended consumers."[2] And although it failed to reach any definitive conclusions, the Bankruptcy Review Commission did point broadly to the rise in consumer debt as a fundamental cause of higher bankruptcies. Proprietary data from Professor Warren, furthermore, suggest that the median income of Chapter 7 debtors has fallen somewhat -- from $23,254 in 1981 to $17,652 in 1997 (1997 dollars), while median nonmortage debt-income ratios have risen from 0.87 to 1.64. Warren also points to the role of divorce and medical emergencies in causing bankruptcies.

On the other hand, several studies (including many financed by the credit card industry) have concluded that social factors -- such as the reduced stigma associated with filing for bankruptcy and the legalization of advertising by lawyers in the late 1970's -- are the primary cause of the increase in bankruptcies. Creditors argue, furthermore, that all consumers pay the price when credit must be priced to reflect the mounting risk of nonpayment stemming from the growing "abuse" of the bankruptcy system by consumers seeking the "easy way out." The total amount of debt involved in Chapter 7 filings during 1997, for example, was estimated at $74 billion ($35 billion in unsecured, non-priority debt, $1.5 billion priority debt, and $38 billion in secured debt). The credit card companies have financed studies concluding that many bankrupts

[2] "Credit Card Defaults, Credit Card Profits, and Bankruptcy," *American Bankruptcy Law Journal*, Vol. 71, 1997.

could afford to repay a significant share of these debts. For example, Ernst & Young has concluded that more than 15 percent of Chapter 7 filers could afford to pay off 20 percent or more of their unsecured, non-priority debt over 5 years. (It should be noted that studies conducted by the Georgetown Credit Research Center, which reached similar conclusions to the Ernst&Young study, have been sharply criticized on methodological grounds.)

The staff-level working group that has been examining this issue has concluded that neither side of the debate has convincingly proven that there is a single cause for the increase in bankruptcies. In fact, it seems likely that the increase results from a variety of causes, and that there is so simple explanation. The group believes that the lack of credible information and analysis cautions against more extreme proposals whose consequences cannot be predicted with any high degree of confidence.

One clear object of any reform proposal, however, must be the Bankruptcy Courts' inadequate data collection system. For example, in frustration with the Courts' slow and limited information collection systems, VISA began collecting its own national bankruptcy data in 1995. But even these data are of questionable value, because they rely solely on self-reported information included in the bankruptcy filings -- which are neither audited nor linked to other, more reliable data sets (e.g., tax returns). Collection of better data was one of the few things on which the National Bankruptcy Review Commission was unanimous, and the Commission made fairly detailed recommendations on what data should be collected and how.

The Current Debate

As noted above, Congress created the National Bankruptcy Review Commission in 1994 to study and report recommendations for legislative change. The debate between consumer advocates and credit card companies was fully aired before the Commission, but the Commission's report did not advocate major changes to consumer bankruptcy laws. In particular, the majority decided to perpetuate *unrestricted* access to Chapter 7 and Chapter 13, the central feature of the consumer bankruptcy system for nearly 60 years.[3] The Commission did, however, propose limiting the range of allowed state exemptions to:

- $20,000 per spouse for personal property;
- $20,000 to $100,000 homestead exemption (a debtor who claims no homestead exemption could claim $15,000 in additional personal property instead);
- Unlimited retirement savings; and
- Unlimited exemption for medical equipment.

[3] NBRC Final Report at 90-91.

Four of the nine Commissioners, however, dissented from this view. Although they did not specifically advocate "means testing" as a consumer bankruptcy reform, they did "disagree most strongly with the...proposals [e.g., increasing exemptions]...that discourage Chapter 13 repayment plans and encourage Chapter 7 liquidations."

Need-based bankruptcy: The Gekas bill

The creditors ultimately took their case to the Congress. They argue that the only way to combat the rise in bankruptcies is to limit access to the full and immediate write-off under Chapter 7 to those who can demonstrate clear need (i.e., those who could not afford to make any significant repayment on their unsecured debt). This approach was first reflected in legislation introduced by Rep. McCullom (R-Fla.) and Rep. Rick Boucher (D-Va.). A more recent version introduced by Rep. George Gekas (R-Pa.) is the focus of current creditor lobbying efforts.

The Gekas bill would preclude access to Chapter 7 to those with income above 75 percent of national median family income, and who could afford to repay 20 percent or more of their unsecured debts during a five-year repayment plan. Ability to repay is measured by taking reported income and subtracting general living expenses (as determined by the IRS Collection Financial Standards for the area in which the debtor lives) and payments on secured and priority debt. The prohibition on access to Chapter 7 would only be lifted under "exceptional circumstances." The Gekas bill also includes a variety of other provisions that would benefit credit card companies (for example, not allowing discharge of any credit card debts incurred less than 90 days prior to filing). According to Ernst & Young, 47 percent of Chapter 7 filers have income above 75 percent of the national median; and 15 percent of Chapter 7 filers have income above 75 percent of the national median *and* could afford to repay 20 percent of their unsecured non-priority debt.[4] In other words, the Ernst & Young analysis suggests that the Gekas bill would force 15 percent of Chapter 7 filers to move to Chapter 13 -- and would move $9 billion in debt (including $4 billion in unsecured non-priority debt) out of Chapter 7 and into Chapter 13.

Critics of the Gekas approach argue that it represents a dangerous and fundamental shift in the bankruptcy code, and does not reflect enough attention to the specific circumstances of individual debtors. For example, a representative from the National Association of Consumer Bankruptcy Attorneys has testified that "far from being needs-based, this test would completely ignore the debtor's needs. Many of my clients have legitimate expenses not included in the IRS expense guidelines...Debtors who would be ineligible for Chapter 7 would be left in the impossible position of being barred from obtaining bankruptcy relief while still being unable to

[4] Ernst & Young, "Chapter 7 Bankruptcy Petitioners' Ability to Repay," March 1998. The Gekas bill has a third constraint: that the debtor have net monthly income above $50. The 15 percent figure cited reflects all three constraints.

pay their debts."[5] The Gekas approach is very strongly criticized by many consumer groups, bankruptcy lawyers, and the former head of the National Bankruptcy Review Commission.

A discretionary approach to needs-based bankruptcy: The Grassley-Durbin bill

An alternative approach to needs-based bankruptcy is reflected in legislation introduced by Senators Grassley and Durbin. The Grassley-Durbin approach would modify Section 707(b), by changing "substantial abuse" to "abuse" and providing guidelines for deciding whether abuse is present (one of the factors listed as a guide is whether the debtor could repay 20 percent of unsecured, non-priority debt based on actual expenses, not IRS expenses). Grassley-Durbin would give standing to file a 707(b) complaint to creditors, although creditors would have to pay debtors' attorney fees and costs if a filing was not substantially justified or if the party brought the motion solely for the purpose of coercing the debtor to waive a right. Grassley-Durbin also restricts repeat filings, compiles new statistics, and makes a variety of other important changes to the bankruptcy code.

The major disadvantage to the discretionary approach embodied in the Grassley-Durbin bill is that it could involve significant administrative costs. (Grassley and Durbin staffers note, however, that the exceptional circumstances appeal possibility under Gekas would also tie up substantial resources -- and they have a letter from a group of judges suggesting that the Gekas approach could be *more* costly.) In addition, the creditor groups do not believe that Grassley-Durbin moves far enough in reforming the code. They note that standards are likely to vary significantly from district to district, and argue that the approach is inefficient and overly bureaucratic. They add, furthermore, that such an approach does not represent a fundamental shift in the bankruptcy system -- which is what is needed to stem the rapid increases in filings.

A debtor-oriented approach: The Nadler bill

A different understanding of the problem underlies legislation introduced by Representative Jerry Nadler (D-NY). Nadler views the rise in bankruptcy as caused primarily by excessive extension of credit. Nadler is particularly outraged by credit card companies whose minimum payments would not amortize the outstanding balance over a reasonable period of time (for example, some minimum payments would not pay off the outstanding balance for 70 or 80 years). Nadler's approach would thus disallow claims based on debt that was extended to an individual "which caused...the debtor's aggregate unsecured debts to exceed 40 percent of the debtor's annual income," or that was "incurred in or adjacent to a gambling facility," or that arises from a consumer debt on "which a billing statement provided by the creditor...would not amortize the debt over a 15 year period."

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[5] Testimony of James Shulman before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives, March 10, 1998.

Critics of the Nadler approach argue that it is unlikely to deter much bankruptcy filing, and if anything, would cause more rapid increases in filing. They also note that many of its provisions would be difficult to implement. The Nadler approach would be entirely unacceptable to the creditor groups.

Reform Elements and Options

The Gekas and Grassley-Durbin bills have been winding their ways through the relevant sub-committees, and are expected to move to full committee and perhaps the respective floors sometime this spring. A House sub-committee mark-up is scheduled for this Thursday, and the Senate Judiciary Committee is scheduled to mark-up next week. On the House side, Congressman Meehan is developing a substitute for Gekas that would follow the basic outline of the Grassley-Durbin approach, but improve it in several technical ways. On the Senate side, Senator Hatch is considering an amendment to replace the Grassley-Durbin discretionary approach with the Gekas provisions.

Given the complexity of the issues involved and the vast differences between the Gekas and Grassley-Durbin approaches, it is not at all clear how quickly legislation could actually be passed by the Congress. Nonetheless, the issue is attracting increasing attention -- and anything is possible. The Administration is therefore faced with a set of substantive and strategic decisions about whether, how, and when to express our views.

Assuming that our objective is to find a balance between debtor and creditor interests, the Administration would have to combine a variety of different elements into an overall package. For example, an Administration approach could involve some form of needs-based access to Chapter 7; restricting exemptions; and policies to address overexetension of credit. Each is these is discussed briefly below.

Needs-based access to Chapter 7

The most controversial aspect of the current debate is whether some restrictions should be imposed on access to Chapter 7 -- the so-called "needs-based" approach to bankruptcy, under which only those who "need" the immediate discharge available under Chapter 7 are allowed access to it. As discussed above, the Gekas and Grassley-Durbin bills both address this issue in some form. The major difference is that the Grassley-Durbin approach is *discretionary*, since it relies on Section 707(b) and leaves the final decision about whether filing under Chapter 7 is appropriate up to the judge. The Gekas bill, on the other hand, involves a mostly non-discretionary rule, in which access to Chapter 7 is based on an income test (although there is a potential escape clause for "exceptional circumstances," and only experience would tell how effective that clause would be in tailoring outcomes to individual circumstances). In other words, the Gekas approach would explicitly keep certain types of bankrupts out of Chapter 7. The Grassley-Durbin approach would allow everyone into Chapter 7, but then remove some who were inappropriately there.

The staff-level working group is split on how to proceed. Most involved support some form of needs-based approach, as long as it is balanced by other changes in the code to ensure that the overall package does not unduly favor either creditors or debtors. The economic agencies are somewhat concerned that acting through Section 707(b) may not have any real effect, on average. Other agencies argue that the discretionary approach embodied in the Grassley-Durbin approach is preferred -- because it would not represent as dramatic a shift in the bankruptcy code, and because it allows us to align ourselves with a possible emerging bipartisan approach to the issue.

The creditors are adamant that the Gekas approach is the only way to limit abuses. Consumer groups are generally opposed to needs-based approaches, but may be willing to accept some tightening of Section 707(b).

Exemption approaches

One approach to restricting abuse of Chapter 7 is to limit the exemptions that allow bankrupts to shield some assets from being liquidated. As noted above, the variance in state exemption levels is massive -- and difficult to justify on any substantive grounds. Furthermore, unlimited exemptions in some states have contributed to several sensational cases that do not reflect the typical bankruptcy case, but have nonetheless provided ammunition for those who advocate sweeping changes. Many reformers -- including the National Bankruptcy Review Commission -- have therefore concluded that the Federal government should place limits on state exemptions. But Federal action is likely to be viewed as trampling on states' prerogatives.

There are two possible middle grounds between no action on exemptions and an explicit Federal limit on state exemptions. One approach, which is included in the Nadler bill, is to limit abuses of state exemptions by prohibiting transfers of $100,000 or more into property with unlimited exemptions within 1 year prior to the bankruptcy filing. This approach would not set an explicit limit on state exemptions, but would address the most flagrant abuses of the exemption system (e.g., those about to declare bankruptcy diverting millions of dollars into exempt assets). A second approach would be to set up a commission to study the exemption system. The commission could then report back to Congress under a special rule, allowing only an up-or-down vote on the recommendations. The constitutionality of this approach is not clear.

Overextension of credit

The staff-level working group has been considering a variety of steps that could be taken to provide balance to an overall package, by providing disincentives for inappropriate extension of credit. For example, one possibility would be to order unsecured, non-priority debts at bankruptcy in inverse relation to the interest rate they carry. In other words, a low-interest debt would have priority over a higher-interest debt. CEA argues that such a system would provide incentives for creditors to avoid risky lending, since such risky lending would presumably carry a higher interest rate and therefore be put at the bottom of the priority pool. Others argue that such a system would represent a major change in prioritization and vastly complicate the bankruptcy procedure. Others believe there will be little practical effect on creditors because now most unsecured creditors get little if any on the dollar.

Another approach is embodied in the Nadler bill: to disallow certain claims in bankruptcy because the credit was extended in an irresponsible manner. There may be serious technical difficulties in implementing the system proposed by Nadler (for example, would a doctor or lawn specialty firm also be subject to the provisions, if their claims were the ones that pushed a debtor over the specified debt-income ratio?).

A third option would be to address credit concerns outside the bankruptcy code. For example, disclosure requirements could be adopted to show debtors how long it would take to pay off their loans at the given minimum payment. Or the minimum payment could be required to amortize the outstanding balance over a relatively short time horizon. The Office of Thrift Supervision has produced a model disclosure form that it believes would help consumers make more informed choices about their credit balances. Pursuing this option, however, would raise jurisdictional issues on the Hill.

Tactical and Strategic Choices

In addition to the substance of our position, we face a series of tactical and strategic decisions about how to achieve the best outcome. As just one example, some believe that if we want to discourage support for the Gekas approach, our best move would be to send a signal -- perhaps through a short, general letter -- that we have concerns about it over the next two days, before the House subcommittee activity tomorrow or the Senate full committee activity next week. Thus far, however, we have stayed above the fray. An alternative perspective, therefore, is to remain more removed for now -- to give ourselves more time to reach an internal decision, and to see how the Hill proposals develop. The danger with that approach is that it risks allowing the Gekas approach to gather momentum, which could expose us to difficult choices later.

Bankruptcy

DRAFT

Senator Orrin Hatch
Chairman
Senate Judiciary Committee
U.S. Senate
Washington, DC

Dear Mr. Chairman,

I am writing to express the Administration's general views on consumer bankruptcy reform proposals currently under consideration in the Congress.

Over the past two decades, consumer bankruptcy filings have risen sharply. While there are many contending theories on the cause of that increase, it is clear that there is no single explanation. Nonetheless, the growing number of filings, examples of abuse of Chapter 7 and state exemptions, and evidence of imprudent extensions of credit suggest some changes to the consumer bankruptcy laws are appropriate. The lack of definitive evidence about the reasons for the rise in bankruptcies means that it is difficult to predict the effect of reform efforts. The Administration, therefore, has developed the following set of principles to guide its review of changes to the consumer bankruptcy laws.

1. **Access to Chapter 7 should not be governed by an arbitrary means test; the court must have discretion to fairly account for the great variations in circumstances that bring debtors into bankruptcy (including medical expenses, unemployment, divorce, responsibility for the care of others, etc.) . To promote more uniform application of bankruptcy standards, this determination should take place within indicative or presumptive guidelines established by Congress that take into account factors such as the debtor's income and ability to repay a portion of the debt.**

2. **National bankruptcy policy can respect state variation in exemption levels without allowing state exemptions to be used to shield luxury assets from creditors.**

3. **It is appropriate to expect debtors who can afford to repay a portion of their debts (taking into account all relevant circumstances) to act responsibly; but the bankruptcy and credit reporting system should reward those who complete a Chapter 13 plan.**

4. **Bankruptcy reform should not create opportunities for creditors to coerce debtors to forgo bona fide rights in bankruptcy.**

5. **Bankruptcy rules should discourage bad faith repeat filings and other attempts to abuse the privilege accorded by access to bankruptcy.**

6. Child support and alimony payments should be carefully protected.

We must ensure that reforms have no unintended adverse impact on debtors' ability to meet these, and other, priority payments.

7. Bankruptcy data collection and accuracy must be improved.

Analysis and understanding of the forces affecting bankruptcy filings are impeded by the lack of high-quality, nationally uniform data. Better data collection and verification procedures should be incorporated in any reform proposals. Such data can be used to assess and monitor the impact of reform legislation.

8. Scrutiny must also be given to credit industry practices that have led some borrowers to overextend themselves.

While some of these issues may fall outside of the Judiciary Committee's jurisdiction, Congress and the Administration should consider proposals to ensure that consumers are well informed about the dangers of excessive debt accumulation and understand the implications of their credit agreements.

The Clinton Administration is open to responsible consumer bankruptcy reform that meets these principles. We have reluctantly concluded that we cannot support H.R. 3150 in its present form. We would look forward to working with Congress toward legislation more similar to the approach of S. 1301 -- with modifications necessary to meet the principles articulated above.

Sincerely,

Message Sent To: ______________________________