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BANKRUPTCY REFORM

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BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

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CONTENTS

STATEMENTS OF COMMITTEE MEMBERS

Page

Biden, Hon. Joseph R., Jr., a U.S. Senator from the State of Delaware, prepared statement 75
Cornyn, Hon. John, a U.S. Senator from the State of Texas, prepared statements 83
Durbin, Hon. Richard J., a U.S. Senator from the State of Illinois, prepared statement 93
Feingold, Hon. Russell D., a U.S. Senator from the State of Wisconsin, prepared statement 96
Grassley, Hon. Charles E., a U.S. Senator from the State of Iowa, prepared statement 98
Kennedy, Hon. Edward M., a U.S. Senator from the State of Massachusetts ... 3
prepared statement 107
Leahy, Hon. Patrick J., a U.S. Senator from the State of Vermont 3
prepared statement 110
Schumer, Hon. Charles E., a U.S. Senator from the State of New York, prepared statement 2
Specter, Hon. Arlen, a U.S. Senator from the State of Pennsylvania 1

WITNESSES

Beine, Kenneth H., President, Shoreline Credit Union, Two Rivers, Wisconsin 5
Bennett, Malcolm, President, International Realty Investments, Inc., Los Angeles, California 14
McCall, David, Director, District 1, United Steel Workers of America, AFL–CIO, Columbus, Ohio 18
Menzies, R. Michael, President and Chief Executive Officer, Easton Bank and Trust Company, Easton, Maryland, on behalf of the the Independent Bankers Association 20
Strauss, Philip L., Retired Attorney, Family Support Bureau, Office of the District Attorney, San Francisco County, California, on behalf of the National Child Support Enforcement Association 16
Vullo, Maria T., Paul, Weiss, Rifkind, Wharton and Garrison LLP, New York, New York 7
Warren, Elizabeth, Leo Gottlieb Professor of Law, Harvard Law School, Cambridge, Massachusetts 10
Zywicki, Todd J., Visiting Professor of Law, Georgetown University Law Center, Washington, D.C. 12

QUESTIONS AND ANSWERS

Responses of Maria T. Vullo to questions submitted by Senator Specter 43
Responses of Todd J. Zywicki to questions submitted by Senators Sessions and Coburn 48

SUBMISSIONS FOR THE RECORD

Abbott, Greg, Attorney General of Texas, Austin, Texas, letter 52
American Bar Association, Robert D. Evans, Director, Government Affairs Office, Washington, D.C., letter 53
American Land Title Association, Ann vom Eigen, Legislative and Regulatory Counsel, Washington, D.C., letter 59

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00003 Fmt 5904 Sfmt 5904 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

Page

Beine, Kenneth H., President, Shoreline Credit Union, Two Rivers, Wisconsin, prepared statement 61
Bennett, Malcolm, President, International Realty Investments, Inc., Los Angeles, California 69
Clements, Richard R., Law Offices of Richard R. Clements, Long Beach, California, letter 79
Commercial Law League of America, Mary K. Whitmer, President, Jay L. Welford, Co-Chair, National Governmental Affairs Committee, Peter C. Califano, Chair, Legislative Committee Bankruptcy Section, Alan I. Nahamias, Chair, Bankruptcy Section, Judith Greenstone Miller, Co-Chair, National Governmental Affairs Committee, Chicago, Illinois, letter 81
Cooper, Corinne, Tucson, Arizona, letter 88
Creel, L.E., III, Creel & Moore, L.L.P., Dallas, Texas, letter 90
Danner, Dan, Senior Vice President, Public Policy, National Federation of Independent Business, Washington, D.C. 92
Greendyke, William, Partner, Fulbright & Jaworski L.L.P., Houston, Texas, letter 104
Harshbarger, Scott, Murphy, Hesse, Toomey & Lehane, LLP, Boston, Massachusetts, letter 105
LoPucki, Lynn M., Security Pacific Bank Professor of Law, University of California, Los Angeles, School of Law, Los Angeles, California, letter 113
McCall, David, Director, District 1, United Steel Workers of America, AFL–CIO, Columbus, Ohio, statement 114
Manney, Mark, McClain, Leppert & Maney, Houston, Texas, letter 116
Menzies, R. Michael, President and Chief Executive Officer, Easton Bank and Trust Company, Easton, Maryland, statement and attachment 117
Moschella, William E., Assistant Attorney General, Office of Legislative Affairs, Department of Justice, Washington, D.C., letter and attachment 139
Munsch, Russell L., Munsch Hardt Kopf & Harr PC, Dallas, Texas, letter 142
National Association of Credit Management, Robin Schausell, CAE, President, Columbia, Maryland, letter 143
National Association of Federal Credit Unions, Arlington, Virginia, statement 145
National Association of Realtors and the Institute of Real Estate Management, Washington, D.C., joint statement 153
Pelofsky, Joel, Spencer Fane Britt & Browne LLP, Kansas City, Missouri, letter 155
Small, A. Thomas, Bankruptcy Judge, Eastern District of the North Carolina, and Eugene R. Wedoff, Chief Bankruptcy Judge, Northern District of Illinois, proposal 157
Spears, Berry D., Winstead Sechrest & Minick, Austin, Texas, letter 193
Strauss, Philip L., retired Attorney, Family Support Bureau, Office of the District Attorney, San Francisco County, California, statement and attachment 195
Tucker, J. Maxwell, Winstead Sechrest & Minick, Austin, Texas, letter 218
Vullo, Maria T., Partner, Paul, Weiss, Rifkind, Wharton and Garrison LLP, New York, New York, statement 220
Warren, Elizabeth, Leo Gottlieb Professor of Law, Harvard Law School, Cambridge, Massachusetts, prepared statement, attachments and letter 227
Westbrook, Jay L., Benno C. Schmidt Chair of Business Law, University of Texas at Austin, Austin, Texas, letter 238
Williamson, Brady C., LaFollette Godfrey & Kahn, Attorneys at Law, Madison, Wisconsin, letter 240
Woodward, William J., Jr., Professor of Law, Temple University, James Beasley School of Law, Philadelphia, Pennsylvania, letter 242
Zywicki, Todd J., Visiting Professor of Law, Georgetown University Law Center, Washington, D.C., statement 243

BANKRUPTCY REFORM

THURSDAY, FEBRUARY 10, 2005

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 10:15 a.m., in room SD–226, Dirksen Senate Office Building, Hon. Arlen Specter, Chairman of the Committee, presiding.

Present: Senators Specter, Grassley, Sessions, Cornyn, Brownback, Coburn, Leahy, Kennedy, Biden, Feinstein, Feingold, Schumer and Durbin.

OPENING STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Chairman SPECTER. The hour of 10:15 having arrived, we will commence this hearing of the Judiciary Committee.

The bill we will be discussing today, S. 256, seeks to address existing bankruptcy abuses, while implementing appropriate consumer protection. It enjoys strong bipartisan support in the Congress and has come close to enactment into law on more than one occasion.

Bankruptcy reform initiatives have been considered by the Congress since 1998, and today's hearing will mark the 11th hearing convened by the Judiciary Committee on this or similar bills. Our counterparts in the House of Representatives have also held numerous hearings on this legislation. The Committee is holding hearings today to give an opportunity for renewed consideration to the pending legislation, even though there have been very many hearings in the past. This legislation has been one of the priority items of the Majority Leader and it is our hope to bring it up on the Judiciary Committee executive session a week from today.

We are starting this hearing just a little later than we customarily do because we have had a meeting among Republicans on asbestos litigation. This has been a very busy time for our Committee, after having the hearings on Attorney General Gonzales and then moving last week to the class action bill, which we were able to report out of an executive session in a morning, which was prompt action for the Committee.

The class action bill is on the floor today. We will renew the discussion at 11:30 and I will absent myself for a sort time to go over to open the hearings. We will open the floor action, but the bankruptcy hearings will continue during my absence and I will return, because we want to hear everybody and have an adequate opportunity for questioning by the panel.

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We have a very distinguished array of witnesses, and I believe that we have two of our colleagues here today to make introductions. Senator Schumer wishes to make an introduction. Senator Schumer is entering right on cue.

I just mentioned you, Senator Schumer, and your interest in making an introduction.

STATEMENT OF HON. CHARLES E. SCHUMER, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator SCHUMER. Well, thank you, Mr. Chairman, and I want to thank you for this opportunity. Ms. Vullo has come down. There are all sorts of things going on. I don't know; you may not want this public, but she is doing a lot of nice things in family and she came down because she cares so much about this. I want to welcome her back. She is an accomplished attorney from my State. She has spent years fighting pro bono for the victims of violence, vandalism and harassment in providing safe and legal health services.

For those who don't remember or were not here then, were not members of this Committee, Ms. Vullo is here to remind us that the Bankruptcy Code should not be used as a safe haven for those who practice and are convicted of violence, no matter what their views on choice.

I know it was not easy for Ms. Vullo to get here. I know she has to leave early, but she knew how important it was to be here to make the case. I remember Senator Biden was very impressed with her testimony when she came a few years back.

Now, Mr. Chairman, since we were here last, the make-up of the Senate has changed and the make-up of the Committee has changed, but what hasn't changed is the need for real, honest and fair bankruptcy reform. And what hasn't changed is the need for an amendment to the current bill that prevents those who engage in violence and intimidation at clinics from hiding behind the Bankruptcy Code to escape court-imposed fees.

The FACE amendment, which passed in the Senate 80 to 17, makes clear to those who would terrorize, use violence or threaten violence against women and doctors that bankruptcy is no escape from accountability. At the same time—and I underline this—it will do no harm, no harm, to legitimate protesters who are peaceful and who do not engage in violence or threats.

So I hope now, as we reconsider this bill, that my colleagues will not do an about-face and oppose this critical measure. As I have said before, it is not pro-choice or pro-life; it is pro-rule of law and anti-violence. We are going after abuses of bankruptcy in this law and there is no reason why this abuse of bankruptcy shouldn't be included as well.

I want to thank Ms. Vullo for making this case, and I ask unanimous consent that my entire statement be placed in the record.

Chairman SPECTER. Without objection, your full statement will be made a part of the record.

Senator SCHUMER. Thank you for your courtesy, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Schumer.

[The prepared statement of Senator Schumer appears as a submission for the record.]

Chairman SPECTER. Senator Kennedy, I yield to you for an introduction.

STATEMENT OF HON. EDWARD M. KENNEDY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KENNEDY. Thank you very much, Mr. Chairman. It really is a great pleasure for me to introduce Elizabeth Warren, who serves as the Leo Gottlieb Professor of Law on the faculty of Harvard Law School and really is one of our Nation's leading experts on bankruptcy law.

She is often cited for her studies on the economic squeeze on middle-class families, as well as the economics of debt, health care finance and other economic stresses. She also works on policy issues relevant to corporate reorganization and sovereign insolvency. The National Law Journal has named Professor Warren one of the 50 most influential women lawyers in America, and her students at Harvard have awarded her the Sachs and Freund Award for teaching excellence.

So we look forward to Professor Warren sharing her expertise with us. We thank her very much for being with us today.

[The prepared statement of Senator Kennedy appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Senator Kennedy.

I now yield to my distinguished ranking member, Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you, Mr. Chairman. Thank you for having this hearing. This is the first hearing on bankruptcy reform we have had in 4 years. It is long overdue. I am delighted you are doing it.

I also would note that the Nation faces a lot different things than it did 4 years ago. We endured the terrorist attacks of September 11th that only deepened the financial woes of this country. We have been witness to a parade of financial misdeeds by major U.S. corporations. The names of Enron, WorldCom, among others, left a bitter taste in the mouths of average Americans. They have damaged investor confidence. They have shaken our capital markets. Financially-troubled companies have short-changed their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk.

Since we last held a hearing on bankruptcy reform, 782,000 private sector jobs have been lost. Far too many Americans are working and barely making ends meet even when they are holding down two and three jobs. And we are immersed in wars in Afghanistan and Iraq with no end in sight.

So I think when we discuss bankruptcy reform, we should do it in the context of real-life developments since 2001. To be appropriate and fair, the key provisions have to be carefully examined. This week, the Majority Leader, Senator Frist, said the following about bankruptcy reform legislation, quote, "It has been several Congresses since people have really looked at the bill very carefully. So we thought it was important to have hearings and have

the opportunity to mark it up and modernize it before taking it to the floor."

I agree with Senator Frist. We should modernize the legislation, but we should take into account what has happened since 2001. For example, we should strengthen the financial safety nets for middle-class American families confronting illness or injury. Medical problems, I am told, contribute to about half of all bankruptcies, even though most of those who filed had health insurance when they first became sick.

Many lose their jobs and their insurance because their conditions worsen, while others face thousands of dollars in copayments and deductibles not covered by their insurance. I am pleased Professor Warren is here and she could join us in discussing her recent research and analysis of illness and injury as they relate to bankruptcy.

We should provide for more disclosure of information so that consumers may better manage their debts and avoid bankruptcy altogether. U.S. consumer debts have reached staggering levels, after more than doubling over the past 10 years. Consumer debt hit $1.98 trillion in October 2003, up from $1.5 trillion three years ago. Credit card debt is at $735 billion. The average household has a balance of a little over $1,200.

I know that Senators Grassley, Durbin, Schumer and others share a commitment to include credit industry reforms in a fair and balanced bankruptcy bill. The millions of credit card solicitations made to American consumers over the past years have contributed to the rise of consumer debt.

It doesn't give me a huge amount of confidence as a Senator when I have a neighbor whose dog gets a credit card with a line of credit already on it. It makes me wonder sometimes when I hear the crocodile tears of some, if this may have something to do with it. Or when you try, as I did the other day, just as an experiment to get my frequent-flyers numbers back and they put you on hold for 34 or 38 minutes, hoping that you will hang up and they don't have to actually come through with something, I lose a little bit of confidence.

Additional disclosure is needed to ensure that consumers completely understand what is in there. When you get the credit card, you want to know just what you are getting. We have to be careful that our efforts to ensure accountability don't inadvertently create problems for privacy and security. We are in an age where personal information can be easily digitized and shared. If it falls into the wrong hands, it is abused. Identity theft is one danger, as is tracking and harassing a battered spouse. We ought to look at how we can cut down on that.

And then look at the economic hardships faced by service members' families. That warrants our attention. Calls to serve their country in Iraq, Afghanistan or elsewhere can cause loss of family income, the closing of a family business, or additional expenses. Senators Durbin, Graham and others have taken an interest in this issue, and I will look forward to working with them.

Now, there is one thing that has not changed. The campaign of violence, vandalism and intimidation continues to curtail the availability of family services and endangers providers and patients.

The perpetrators of such violence continue to escape judgment through bankruptcy abuse. I want to applaud the senior Senator from New York for his work in this area.

The 501-page bankruptcy reform bill introduced a few days ago has been stripped of the consensus clinic violence language. It fails to address the discharge of penalties for violence against family planning clinics. Such people can commit violence and escape. We should look at that, and I am looking forward to hearing from Ms. Vullo, who, as Senator Schumer has mentioned, has done a huge amount of pro bono work in this area.

The rest of my statement, Mr. Chairman, I will put in the record. We have a lot of work ahead of us. I think this is an important hearing and I compliment you again for holding it.

Chairman SPECTER. Thank you very much, Senator Leahy, and without objection, your full statement will be made a part of the record.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Chairman SPECTER. Our practice at the Judiciary Committee is to have 5 minutes for the witnesses to testify, and I would appreciate it if you would observe the large timing lights in front of you: green, continue; amber, one minute left; and the red, stop.

Senator BIDEN. Mr. Chairman, can you yield to me for five seconds? I have a hearing in the Foreign Relations Committee on the tsunami and the President's request for about $1 billion, which I think is appropriate.

I want to make clear to the witnesses that my coming in and out of this hearing is not a lack of respect. Senator Grassley and I have been working on this for 8 years. I am anxious to get it resolved. So my failure to be here is not a lack of interest, but I will be in and out.

Chairman SPECTER. Well, thank you, Senator Biden, for those comments. That applies to other Senators, as well. There are hearings going on all the time and there is floor action, so it is no disrespect or lack of interest if Senators move in and out of the hearing.

Our first witness is Mr. Kenneth Beine, who appears today on behalf of the Credit Union National Association. He is president of Shoreline Credit Union, a Wisconsin native, a graduate of the University of Wisconsin in 1974, with a master's in finance from the University of Wisconsin in 1984.

Thank you for joining us, Mr. Beine, and we look forward to your testimony.

STATEMENT OF KENNETH H. BEINE, PRESIDENT, SHORELINE CREDIT UNION, TWO RIVERS, WISCONSIN, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Mr. Beine. Thank you. Good morning, Chairman Specter and other members of the Committee. I am Kenneth Beine, President of Shoreline Credit Union, in Two Rivers, Wisconsin. We are a $64 million State-chartered, federally-insured credit union. I appreciate the opportunity to be here to tell you about our concerns with bankruptcies and how they are impacting credit unions, and my credit union in particular.

I am speaking on behalf of the Credit Union National Association, which represents about 90 percent of the 9,100 State and Federal credit unions nationwide. We are very pleased that the Committee is holding today's hearing on S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

I sat in front of this Committee nearly 4 years ago today with a message from America's credit unions. That message is the same today as it was then. Credit unions recognize that many people legitimately need the option to declare bankruptcy. What concerns us, however, are the cases of abuse by those who file Chapter 7 and totally walk away from their debt even though they clearly have the ability to pay part or all of that debt.

Credit unions have consistently had three top priorities for bankruptcy reform legislation: a needs-based formula, mandatory financial education, and maintenance of the ability of credit union members to voluntarily reaffirm their debts. The bill before you today, while a product of compromise, does a good job of balancing these issues. We strongly urge the Senate to pass this compromise bill as soon as possible.

CUNA strongly supports the provision in S. 256 that requires a person contemplating bankruptcy to receive a briefing about available credit counseling and assistance in performing a budget analysis. We also strongly support the provision in this legislation that would prohibit the Chapter 7 or 13 debtor from receiving a discharge if the debtor does not complete a course in personal financial management.

Any sensible bankruptcy reform should include education requirements to give debtors the tools they need to make wise decisions about filing for bankruptcy and, more importantly, to succeed financially after bankruptcy. In anticipation of this, CUNA plans to develop face-to-face and/or online courses to fulfill this aspect of the legislation.

I am confident that early financial education would have helped some young adult members of Shoreline Credit Union to make different decisions than they did. In one case, a couple in their mid-20's decided they wanted a clean slate prior to getting married. They ran up credit card purchases. One prepaid on auto loan with us to have the cosigner, their parent, removed. Both were employed full-time. They both then filed Chapter 7. My credit union's share of their version of financial planning was a write-off of almost $3,000 in credit card balances, plus several hundred dollars on disposal of the automobile.

Credit unions strongly believe that reaffirmations are of benefit both to the credit union which would avoid a loss and to the member debtor who, by reaffirming with their credit union, continues to have access to financial services and to reasonably-priced credit.

Let me digress for a moment. We do not remove members who have a loss. We encourage them to continue to have a relationship with us and continue to have savings accounts. We also offer checking to those people so they can continue to conduct business. We do not want to contribute anybody to the unbanked. As not-for-profit financial cooperatives, losses to the credit unions have a direct impact on the entire membership due to a potential increase in loan rates or a decrease in interest on savings accounts.

Perhaps the best demonstration of the credit union movement's position that reaffirmation benefits both the member and the credit union comes from another real-life example. We had a middle-aged couple file for Chapter 7 due to several medical problems and loss of employment. They reaffirmed their automobile loans with Shoreline. Although not required to repay their credit card loans, they were adamant about doing so and did so quite voluntarily after discharge. Needless to say, they are members today in good standing and they only ask to be granted a loan.

Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that needs-based bankruptcy presents the best opportunity to achieve these important public policy goals. Credit unions believe that consumers who have the ability to repay all or part of their debt should be required to file a Chapter 13 rather than have all their debt erased in Chapter 7. Therefore, CUNA supports the needs-based provision that is contained in S. 256.

We hope that today's hearing shows that the Senate is moving toward passage of bankruptcy abuse reform legislation, and we hope that bankruptcy reform will become law in the coming weeks. As I said earlier, I was here 4 years ago. It is an honor to be called back.

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

[The prepared statement of Mr. Beine appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Beine.

We now turn to Ms. Maria Vullo, partner in the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP. She received her law degree from the New York University School of Law in 1987 and holds a bachelor of arts degree in political science from the College of Mt. Saint Vincent. She clerked for Judge MacKenzie in the district court in the Eastern District of Virginia.

Thank you for joining us today, Ms. Vullo, and the floor is yours.

STATEMENT OF MARIA T. VULLO, PAUL, WEISS, RIFKIND, WHARTON AND GARRISON LLP, NEW YORK, NEW YORK

Ms. Vullo. Thank you, and good morning, Mr. Chairman and Senator Leahy and the rest of the Committee. Thank you, Senator Schumer, for your kind words.

As the Chairman mentioned, my name is Maria Vullo and I am a partner at the law firm of Paul, Weiss, Rifkind, Wharton and Garrison, based in New York. And I appear again before this Committee. I was here, I think it was, in February of 2001, and I am testifying from my personal experience regarding a present loophole in the United States Bankruptcy Code that I very strongly believe needs to be fixed to prevent further abuse of the bankruptcy process by persons who are seeking to evade judgments that have been obtained through extensive litigation under the Freedom of Access to Clinic Entrances Act, also known as the FACE statute.

I have been for almost ten years now—time goes by quite quickly—lead counsel for the plaintiffs in a case that was pending in Portland, Oregon, called *Planned Parenthood of the Columbia Williamette* v. *The American Coalition of Life Activists.* It is known as the Nuremberg Files case in many other forums.

In February of 1999, after more than 4 years of litigation, and after a one-month trial, we obtained on behalf of our clients a $109 million judgment under the FACE statute to compensate the plaintiffs for out-of-pocket security costs that they were required to incur because of threats of violence by certain extreme members of the anti-choice movement. The jury also awarded punitive damages in large sums against each of the 14 defendants.

Since I appeared before this Committee, the Ninth Circuit, sitting en banc, affirmed the judgment and the injunction that had been issued by the district court. And the United States Supreme Court has denied the defendant's petition for a writ of certiorari, and in the course of those proceedings the Solicitor General, Ted Olson's office, filed a brief in support of my clients' legal positions and the Ninth Circuit's judgment. So there is no question here that the case has been fully litigated. The judgment is valid and the defendants are required to pay it.

That being said, we have experienced, my law firm has experienced, over the past five years since the judgment was first rendered, some very significant obstacles in collecting on the judgment. This experience has led to the proposed amendment to the Bankruptcy Code that I urgently ask this Committee to pass.

Just as a little bit of background, my clients are physicians and family planning clinics who were subjected to threats of violence, including the Nuremberg Files website which had dripping blood and cross-outs of names of physicians who had been murdered, grayed-out names of physicians who had been shot at and wounded, and those who were still working and living were not grayed yet or not crossed out yet. That was a threat of violence that all the courts have said is sanctionable under our country's laws, as it should be.

My clients live and work in relatively safe communities across the country, but have been forced, because of the defendants' actions, to live under a constant threat of imminent attack. They have purchased and regularly have worn, and still wear, bullet-proof vests. They have installed extensive security systems, including bullet-proof glass and reinforced steel in their homes and offices. They have warned their children's teachers of the dangers that they face.

They have developed emergency plans, should they come under attack, including instructing young children to hide in the bathtub when shots are fired. They vary their routes to and from work to protect themselves from assailants. They have installed window coverings to thwart snipers. They have purchased and wear disguises to avoid being recognized by extremists. And, of course, they are ever-vigilant in public. They are not secure in their homes or in their offices. They don't live their lives like we do, and that is un-American and the defendants' conduct is un-American.

The passage of the FACE statute, however, has had a significant impact on the lives and safety of family planning clinic workers. We need the statute and its continued enforcement to save lives, but the statute cannot be fully enforceable if those who are found liable under the statute after years of litigation can simply go into a bankruptcy court or multiple bankruptcy courts, file a Chapter

7 petition, trigger the automatic stay and cause relitigation and relitigation of the same issue.

I experienced this personally in six different bankruptcy courts across the country after the verdict. I was in Jackson, Mississippi; Chattanooga, Tennessee; Norfolk, Virginia; Roanoke, Virginia; Baltimore, Maryland; and Greenbelt, Maryland—quite a list for a girl from Brooklyn.

Following the jury's verdict, the defendants announced that they intended to pay not a cent of the amount awarded by the jury. These are not honest but disfortunate debtors who find themselves unable to pay their credit card debts or mortgage. These are people who do not follow the laws of our country and believe that they can just abuse the bankruptcy process in order to avoid judgments that have been lawfully obtained against them.

My firm has committed enormous research—

Chairman SPECTER. Ms. Vullo, your red light is on. Could you summarize, please?

Ms. VULLO. Sure, sure.

The critics of the amendment that is being proposed may ask why it is needed, given that I won the issue ultimately after three or 4 years of litigation in the bankruptcy courts. And to this, I have two quick responses.

First, an amendment that will make clear what the law already provides should not be controversial. Secondly, the amendment is needed most importantly because with it debtors will not be able to abuse the Bankruptcy Code by invoking the automatic stay, causing relitigation. It is very simple to make it unambiguous in the Bankruptcy Code that you cannot abuse the bankruptcy process and the automatic stay provision by filing for bankruptcy and causing relitigation. Just state in the statute that FACE judgments are non-dischargeable.

Chairman SPECTER. Thank you.

Ms. Vullo. Let me just—

Senator SCHUMER. Mr. Chairman, this is important. It is the only witness on this controversial amendment. The witness came at great trouble to herself. Could she just be given another two minutes to make the end of her statement? I know that is asking a good deal with the amount of witnesses.

Chairman SPECTER. There will be time for—

Senator SCHUMER. She has to leave, Mr. Chairman. She flew down this morning and has to leave right after she speaks.

Chairman SPECTER. When do you have to leave, Ms. Vullo?

Ms. VULLO. I have to be in court this afternoon in the Southern District of New York. I am caught between United States Senators and a United States Federal judge.

Chairman SPECTER. When do you have to leave, Ms. Vullo?

Ms. VULLO. I have to leave no later than getting on the one o'clock shuttle, so I have to leave by noon.

Chairman SPECTER. How much more time would you like, Ms. Vullo?

Ms. VULLO. I just need a couple of minutes.

Chairman SPECTER. Go ahead.

Senator SCHUMER. Thank you, Mr. Chairman.

Ms. VULLO. After extensive litigation and considerable expense over a period of four-plus years, as I mentioned, we won the issue in the bankruptcy courts under the current Code which deals with willful and malicious injury. But that does not mean that the Bankruptcy Code worked, because the relitigation demonstrates that it did not work.

Enactment of an amendment is necessary because we had to relitigate the question of willful and malicious injury over and over again. While we won that issue, what we need here is a very unambiguous provision that says judgments under FACE or similar statutes are non-dischargeable in bankruptcy, so you don't have lawyers engaging in sanctionable conduct, as I would submit, going into the bankruptcy courts, triggering the automatic stay and arguing about interpretation, as we lawyers like to do, of language in legislation. This is a loophole that needs to be fixed based upon documented abuse.

I think I have said what I need to say. I strongly urge this Committee to consider an amendment to the Code. It is something that, as a private lawyer litigating this issue for many years, I have personal experience with and feel very strongly about because it is a problem in the Code that needs to be remedied.

Again, I apologize that I have to leave to go to court. If there are any questions—and I recognize other members of this panel and I certainly don't want to impose on them, but I apologize that I have to leave early.

[The prepared statement of Ms. Vullo appears as a submission for the record.]

Chairman SPECTER. Well, thank you, Ms. Vullo.

If any of the other witnesses have any extraordinary time constraints, just let us know and we will try to accommodate you. We have limited the witnesses' testimony to give minutes because our experience has been that when you get to the question-and-answer session, you are responding to matters of greater concern to the members which really is of assistance in the legislative process.

Our next witness is Professor Elizabeth Warren, Leo Gottlieb Professor of Law at Harvard; an extraordinary background on writing, 50 book chapters; principal investigator on a number of empirical studies on commercial law. Her works have appeared in major national publications—Time and Newsweek. She was the reporter for the National Bankruptcy Review Commission and Vice President of the American Law Institute. She has a bachelor's degree from the University of Houston and a law degree from Rutgers.

Thank you for joining us, Professor Warren, and we look forward to your testimony.

STATEMENT OF ELIZABETH WARREN, LEO GOTTLIEB PROFESSOR OF LAW, HARVARD LAW SCHOOL, CAMBRIDGE, MASSACHUSETTS

Ms. WARREN. Thank you, Senator. Thank you for having me.

This bill is 8 years old, and in 8 years bankruptcy has certainly been in the news: Enron, WorldCom, Adelphia, United Airlines, USAir, TWA, LTV Steel, K–Mart, Polaroid, Global Crossing, just to name a few. And many of the companies that have gone into bankruptcy are those associated with scandal. But I notice there is no

response in this bill. There is no response because this bill was written before a lot of new problems were on the horizon: companies that file for Chapter 11 that cancel pensions plans and health benefits, leaving thousands of families economically devastated; companies that continue to pay executives and insiders tens of millions of dollars, while they demand concessions from their creditors; military families targeted for payday loans, insurance scams, and other forms of financial chicanery; scandals that have rocked the so-called nonprofit credit counseling industry; sub-prime mortgage companies that have unlawfully taken millions of dollars from homeowners, then fled to the bankruptcy courts to protect their insiders and bank lenders.

In the 8 years since this bill was introduced, there has been a revolution in the data available to us. Unlike 8 years ago, we need not have a theoretical debate about who uses the bankruptcy system. We now know that 1 million men and women are turning to bankruptcy each year in the aftermath of a serous medical problem, and three-quarters of them had health insurance at the onset of the illness that ultimately bankrupted them. We know that a family with children is nearly 3 times more likely to file for bankruptcy than their counterparts who have no children. And we know that now more children every year live through their parents' bankruptcy than live through their parents' divorce.

The effects on small business also need not be speculated upon. This Congress has the opportunity with this bill to make history. This would be the first law in the history of the United States that would discriminate against small businesses. It would say that the Enrons and WorldComs of the world can go forward with no new disclosures, no supervision by the United States—additional supervision by the United States trustee, no fixed deadline. But if you are a little business, all of those new restrictions will apply. And if you cannot meet them, you are automatically thrown out of bankruptcy under this bill.

Now, we hear a lot about the means test. I remind the Senators with respect, it is one section of 217. But the key part of the means test to think about and all the other provisions that apply to families is they treat all families alike. It treats every family—it assumes that they are all in bankruptcy for the same reason: that they have overspent. This means that a family driven into bankruptcy by the increased costs of caring for an elderly parent with Alzheimer's is treated the same as someone who maxed out his credit cards at a casino. A person who had a heart attack is treated the same as someone who had a spending spree at the mall.

If Congress is determined to sort the good debtors from the bad, then it is both morally and economically imperative that they distinguish those who have worked hard and played by the rules from those who have shirked their responsibilities.

I understand that bankruptcy losses hurt good people. My brother is a small landlord. My sister-in-law works for the Apartment Association. I have another brother who has run a small business. I am a member of a credit union. Those losses are real. No one denies that, and they can make a difference in the bottom line—a 1-percent difference, a 2-percent difference in some cases.

Those creditors are fully entitled to a system that is as free of abuse as we can humanly make it. But I want you to think about the people who are not here today. Think first about the fact that there are no representatives from the credit card industry here today, and yet they are the ones who will scoop up most of the benefit from this bill. As bankruptcies have risen in the 8 years that this bill has been pending by 17 percent, credit card profits, despite not adopting this bill, have gone up by 167 percent. They now top $30 billion annually.

But think of the others who are not here. These are the people for whom bankruptcy law matters 100 percent: the Mom working two jobs trying to pay her bills; the family with a child battling cancer; the reservist who has been called up and lost his small business. These are good people who desperately did not want to file for bankruptcy. A difference in the bankruptcy laws is a 100-percent difference to them—

Chairman SPECTER. Professor Warren, your red light is on.

Ms. WARREN. I will. Thank you. For these people it will be the difference between whether they can save their homes, whether or not they can stop the collection calls that come principally in the afternoons when the children are home from school, whether they can make peace in their lives after a catastrophe has hit them. Please don't change the law without hearing from these people.

[The prepared statement of Ms. Warren appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Professor Warren.

I might add that all of the statements which have been submitted will be made a part of the record in full.

We turn now to Professor Todd Zywicki, Visiting Professor of Law at Georgetown, Professor of Law at the James Buchanan Center, an author of some 40 articles in the fields of bankruptcy, commerce, commercial law, a law degree from the University of Virginia where he was executive editor of the Law Review, and a bachelor's degree cum laude from Clemson.

Thank you for coming today, Professor Zywicki, and we look forward to your testimony.

STATEMENT OF TODD J. ZYWICKI, VISITING PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, D.C.

Mr. ZYWICKI. Thank you. Distinguished Senators, it is a distinct honor to testify before you today on the subject of this bankruptcy reform legislation.

Last year, over 1.5 million people filed bankruptcy in this country. During the past decade, annual bankruptcy filings doubled. In the past two decades, bankruptcy rates have quintupled—this during an era of almost uninterrupted prosperity, high economic growth, low interest rates, low unemployment rates, and rising stock in household real estate markets. More people will file bankruptcy this year alone than during the entire decade of the Great Depression.

Let's make one thing very clear at the outset, then. Record numbers of Americans are not filing bankruptcy because they have to. Many Americans are filing bankruptcy because we have a bank-

ruptcy system that is out of control. We have a system riddled with fraud and abuse. We have a system where rich debtors use bankruptcy to walk away from debts they could repay but choose not to. We have a system where unscrupulous deadbeat fathers hide behind the machinery of the Bankruptcy Code to avoid paying alimony and child support, and divorced women actually have to stand in line behind bankruptcy lawyers to collect money that they are owed in bankruptcy.

We have a system where debtors can abuse the unlimited homestead exemption by relocating on the eve of bankruptcy, leaving creditors in the lurch. We have a system where debtors conceal assets, like about their incomes, and manipulate the system, safe in the knowledge that their malfeasance rarely will be caught. We have a system where lawyers stampede their clients into bankruptcy while never asking whether a debtor should try to avoid bankruptcy through credit counseling.

Senators, we have a bankruptcy system that is broken and must be repaired. It will not fix itself, and in 8 years the problems have not disappeared, and in 8 years the critics of this much needed reform still have offered no plan for fixing it.

Those who turn a blind eye to bankruptcy fraud and abuse ignore its victims. Those victims include the unsuspecting divorcee who is sandbagged by the bankruptcy system when she learns that her property settlement has been discharged; the small businesses that are forced to raise prices, curtail services, or lay off workers to compensate for losses resulting from bankruptcy filings. They include hospitals that are unable to buy new equipment or hire another nurse because of unpaid bills discharged in bankruptcy. They include young and low-income workers who are unable to buy a car because they cannot get a car loan because of out-of-control bankruptcy system. And they include you and me, every American who is forced to pay more for credit, goods, and services because others file bankruptcy and walk away from debts they could pay but choose not to. This is unfair and unnecessary.

This bill rebalances the consumer bankruptcy system in two ways: first, it increases protection against abuse, primarily by institutionalizing a systems of means testing, eligibility for filing Chapter 7; second, it installs important new safeguards against bankruptcy fraud.

The central debate over this legislation boils down to one simple question: Should high-income debtors who can repay a substantial portion of their debts without significant financial or other hardship be required to do so? I believe the answer must be yes.

Bankruptcy is intended as a last resort for those who are poor or unemployed, suffering from health problems, or otherwise down on their luck. Bankruptcy should not be a first resort for those who consciously choose to live beyond their means. Nor should bankruptcy be a mechanism for people to strategically take advantage of the system for financial gain. Means testing will improve the administration of the bankruptcy system, increase the recovery from high-income debtors, protect low-income debtors, and increase public confidence in the fairness and efficiency of the bankruptcy system.

At the same time, means testing will protect the poor and unfortunate debtors for whom bankruptcy is intended. By definition, means testing does not apply at all to the great bulk of bankruptcy filers, the roughly 80 percent of Chapter 7 filers whose incomes are below the median. Nor will it apply to debtors who can demonstrate special circumstances to rebut the means-testing presumption. No honest unfortunate debtor will be denied the right to file bankruptcy under this or any other provision of the legislation.

Does bankruptcy abuse occur? Every day. In one case, a Miami physician who earned over $245,000 per year tried to discharge $265,000 in unsecured debt. In addition to his homestead, he had property in Washington, D.C., with over half a million dollars of equity and three vacant lots in Colorado. I could give additional examples, but I think you get the picture.

This bill would also create numerous new safeguards against the rampant fraud in the system today. The FBI estimates that 10 percent of bankruptcy cases contain some degree of fraud, especially a failure to fully disclose all assets. This legislation includes numerous, simple cost-effective measures to reduce bankruptcy fraud.

Are fraud and abuse of bankruptcy filers the majority of individuals in the bankruptcy system? Senator, may I have 30 seconds to conclude?

Chairman SPECTER. You may.

Mr. ZYWICKI. No. But they are representative of a certain class of bankruptcy filers, those who file bankruptcy not as a result of financial hardship, as conventionally understood, but merely as a convenience to maintain an extravagant lifestyle. This legislation rebalances the bankruptcy system by targeting the worst forms of fraud and abuse in the system while leaving honest bankruptcy filers unaffected. It rewards old-fashioned virtues of thrift and personal responsibility and ends the shameful subsidization of upper-class profligacy by those who are forced to pick up the bill. I urge you to pass it.

Thank you.

[The prepared statement of Mr. Zywicki appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Professor Zywicki.

We now turn to Mr. Malcolm Bennett, who appears here on behalf of the National Multi Housing Council and the National Apartment Association. He is president and founder of the Minority Apartment Owners Association and founder of International Realty and Investments, Incorporated.

Thank you very much for coming from California, Mr. Bennett, and the floor is yours.

STATEMENT OF MALCOLM BENNETT, PRESIDENT AND FOUNDER, INTERNATIONAL REALTY INVESTMENTS, INC., LOS ANGELES, CALIFORNIA

Mr. BENNETT. Thank you, Chairman Specter and other members of the Committee. Thank you for the invitation to be with you here today as you consider S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act. As said, my name is Malcolm Bennett. I am from Los Angeles, California, where I am the founder and president of International Realty and Investments, one of the

largest minority-owned and -operated firms in the area. And, in addition, I formed the Minority Apartment Owners Association, which represents owners throughout Southern California. And today I am here representing the National Multi Housing Council and the National Apartment Association, and I would like to share with you my views as well as the industry views on the current Bankruptcy Code.

While we are certainly in support of comprehensive and meaningful reform of the Bankruptcy Code, I will limit my comments to those that are of most interest to us, and that is the provisions of the automatic stay.

As you are well aware, Section 362 of the Code essentially denies creditors the ability of collection effort when a person files for bankruptcy protection. For those of us in the rental housing community, this means that we are prohibited from continuing with the eviction process. While we certainly realize that the automatic stay provision to give debtors breathing room is a worthy one, however the rental housing industry and renters in general are disproportionately disadvantaged by this provision, especially when it is manipulated by people for personal gain. And I may explain, I have made my work putting people into housing, especially a lot of those that would almost be out of that safety net. And in the majority of cases, it has been tremendously rewarding. Unfortunately, there does come a time when a resident must be removed from his or her rental unit by eviction. Now, understand that as property owners we need tenants, and we would not evict a tenant without cause. And when we do use the eviction process, it is actually the last action that we take. And we do so following strict State laws and procedures which we believe to be fair and protective of the residents.

We really cannot go in and change the locks and take possession of a unit. There are numerous legal matters that arise in the eviction process. On the whole, the average eviction takes about 3 months, and during this time several things happen. Number one, there is no rent being paid by the tenant, and there is obviously the potential for extensive damage because the tenant knows that they are going to eventually be evicted, and there is no way to rerent the apartment. In the meantime, we continue to incur legal bills, ongoing utilities, and other miscellaneous costs associated with a unit that is basically out of service.

Once we have been granted a judgment in a State eviction court, then he or she subsequently files a bankruptcy petition. And as you know, that automatic stay provision stops our eviction right in its tracks. And as a result, residents are allowed to stay in these places rent-free, which could be several additional months. And it is really most absurd when the situations arise out of illegal drug activities when we are mandated to get rid of these people, yet they are allowed to remain in because of the automatic stay. And, in addition, we run the possibility of losing good tenants.

What is even more distressful is there are a lot of unscrupulous opportunities which exploit the automatic stay by going out and passing out to our tenants flyers saying that they can get them extra time by filing all sorts of frivolous motions in the eviction proceedings. Then after all of that fails, then they file for bank-

ruptcy, stalling, which could take another several months. These abuses play out all across the United States, from large multi-family communities to single units.

I would also like to point out that a recent study shows that 47 percent of all rental housing is owned by individuals like me, and 35 percent of all of those are properties with ten units or less. In short, when apartment owners, especially small firms, lose our ability, it is a great significant burden, and the added cost really impacts the low and moderate housing.

Section 311 is a much-needed reform to the automatic stay. While it does not exempt rental housing from the automatic stay, it goes a long way to help the abuse. And what it really does, it denies an automatic stay if the property owner or manager already had a judgment prior to the bankruptcy being filed, and when the property is endangered with illegal drugs or controlled substances. Both of these will allow the owner to gain possession much faster. Also, it provides that needed protection for a tenant that wants to reinstate their entire monetary default and remain in the unit.

At all cost, we try to avoid evictions, and as I move to close, this is an important step to reduce the abuse, and this amendment will go a long way. And I would like to thank you on behalf of the National Multi Housing Council and the National Apartment Association for the opportunity to present these points to you today, and I certainly will entertain any questions.

[The prepared statement of Mr. Bennett appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Bennett, for your testimony.

Our next witness is Mr. Philip Strauss, here on behalf of the National Child Support Enforcement Association, principal attorney for the Legal Division of the Department of Child Support Services in San Francisco; a bachelor's degree in history from the University of California at Berkeley and law degree from the University of California at Hastings.

Thank you very much for joining us, Mr. Strauss, and you are up.

STATEMENT OF PHILIP L. STRAUSS, RETIRED ATTORNEY, FAMILY SUPPORT BUREAU, OFFICE OF THE DISTRICT ATTORNEY, SAN FRANCISCO COUNTY, CALIFORNIA, ON BEHALF OF THE NATIONAL CHILD SUPPORT ENFORCEMENT ASSOCIATION, SAN FRANCISCO, CALIFORNIA

Mr. STRAUSS. Mr. Chairman, members of the Committee, good morning. As you said, I appear on behalf of the National Child Support Enforcement Association, whose membership consists of professionals at the local, State, and Federal Government levels who have the responsibility for administering and implementing the Federal child support enforcement program. I welcome the opportunity to discuss the effect that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 will have on the collection of child support and alimony when the debtor has filed a petition for relief under the Bankruptcy Code.

For the last 31 years I was employed as an attorney for the City and County of San Francisco, and the last 28 I spent enforcing

child support obligations. For the last 16 years, I specialized in the collection of support during bankruptcy and have taught this subject to attorneys both in California and nationally. I have litigated bankruptcy support cases before numerous bankruptcy courts, the District Court for the Northern District of California, Bankruptcy Appellate Panel of the Ninth Circuit, and the Ninth Circuit Court of Appeals. I retired from service in San Francisco in 2004.

Seven years ago, I proposed amendments to the Bankruptcy Code which now appear in S. 256. It is my opinion and the opinion of every professional support collector with whom I have discussed the issue that the child support amendments contained in Sections 211 through 219 of S. 256 will revolutionize the enforcement of support obligations against debtors in bankruptcy. These enhancements will also result in a more efficient and economical use of attorney and court resources.

During the past 17 years in which I have taught the subject of support enforcement during bankruptcy, I have reviewed virtually every court opinion written on the subject since the enactment of the Bankruptcy Code in 1978. Based on this experience, I developed, in association with my colleagues, what essentially became a wish list of amendments to the Bankruptcy Code aimed at facilitating the collection of support from bankruptcy debtors. This wish list is reflected in Sections 211 through 214 and 216 through 217 of S. 256.

The most important amendment is found in Section 214 which removes several impediments to the collection of support. Of these, the most valuable by far is a provision allowing the continued operation of an earnings withholding order for support. Since State courts or administrative agencies have already determined the appropriate level of support and arrearage payment, the removal of withholding orders from the reach of the automatic stay will require a support debtor to design his or her bankruptcy plan to accommodate support debts—which are, of course, the most serious and primary of all financial obligations. Under current bankruptcy law the reverse is true. The support creditor is often forced to take a back seat to ordinary commercial creditors when a support arrearage payment is sought in a bankruptcy case.

Under current bankruptcy law, when a debtor files for protection under Chapter 12 or 13, the collection of even ongoing support is stayed. The economic detriment to the family which is not receiving public assistance can be devastating.

This amendment, therefore, not only ensures that the payment of support by wage earners will not be interrupted, but it will also avoid the need to entangle the debtor's family in the bankruptcy process.

In addition to the removal of the earnings withholding process from the automatic stay, other federally mandated collection processes would be exempt under Section 214 of the bill. These include the interception of the debtor's tax refunds to pay the support obligation; the revocation of debtors' professional, driver's, or recreational licenses for those debtors who are not paying their support; the continued enforcement of medical obligations; and the continued reporting of support delinquencies to credit reporting agencies.

Perhaps the second most important and useful section of the bill is contained in Section 213 which prevents a debtor from obtaining confirmation of a bankruptcy plan and a subsequent discharge if that debtor has not made full payment of all support first becoming due after the petition date. This section is significant for two reasons. It will prevent a support debtor from paying other debts at the expense of familial obligations. And, second, the provision is self-executing. Neither the support creditor, an attorney for the creditor, nor a public attorney will have to seek enforcement of this provision in bankruptcy court.

I know that there has been some criticism that the bill will put child support creditors in competition with banks or financial institutions who have debts that have not been discharged because of this bill. However, there is no professional child support collector who believes that is a serious issue. We have never had a problem collecting support simply because a credit card or a financial institution was collecting support. Therefore, on behalf of the National Child Support Enforcement Association, we urge you to enact this bill so that these amendments can finally be implemented. We have waited a decade for them, and every year that goes by means support that is not collected for children.

[The prepared statement of Mr. Strauss appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Strauss.

Our next witness is Mr. David McCall, here on behalf of the United Steel Workers of America, where he is director of District 1. He has had numerous key positions in the labor movement and leads the union's negotiating committees for Republic Engineered Products, attended the labor studies program at Indiana University, Northwest, and graduated from the Harvard University trade union program.

Thank you very much for joining us today, Mr. McCall, and we look forward to your testimony.

STATEMENT OF DAVID MCCALL, DIRECTOR, DISTRICT 1, UNITED STEEL WORKERS OF AMERICA, AFL–CIO, COLUMBUS, OHIO

Mr. MCCALL. Good morning, Mr. Chairman and members of the Committee. I am a member of our union's International Executive Board and the USWA district director for the State of Ohio, a State that has lost over 200,000 jobs in the last 5 years, a State where our union and the workers and the retirees we represent have experienced bankruptcies at such companies as LTV Steel, Ormet Aluminum, Warren Consolidated Industries, Republic Engineered Steels, and Wheeling-Pittsburgh Steel, which are among the largest. Beyond Ohio, our union of over 1 million active and retired steelworkers has experienced bankruptcies at other locations such as Bethlehem Steel, National Steel, Kaiser Aluminum, and many other companies. Given the importance of bankruptcy law to the lives of our workers and our retirees, you can be sure that our International President, Leo Gerard, would be here today if he were not out of the country. But on his behalf, my own, and our union, we certainly thank you for holding these hearings and considering the perspectives that we offer.

By itself, bankruptcy law cannot solve the many problems facing the American worker and pensioners today. It cannot roll back a flood of illegal imports that may undermine a plant or an industry, and it cannot directly challenge the transferring of manufacturing jobs to other countries. Nor can it necessarily close the widening gap between rich and not-so-rich in our country or solve the problems of our health care and pension systems. When these forces do drive companies under, our bankruptcy law should treat workers and retirees and their families as fairly and as humanely as possible.

Most of the bill now before this Committee addresses consumer bankruptcies, but over the life of this bill and its predecessors, our union and the rest of the AFL–CIO have viewed S. 256 generally as rendering wholesale changes in the consumer bankruptcy system that would shift the rules decidedly in favor of creditors and to the detriment of individuals.

Let me offer four points based on the experience of our union with manufacturing companies in bankruptcy. And much of this experience comes after and before the waves of bankruptcy in manufacturing.

First, it is hard to say what is the worst thing about bankruptcies in manufacturing, whether it is the loss of tens of thousands of jobs and the impact on workers and their families; whether it is the extreme economic shock to the affected communities; whether it is the loss of hard-earned and promised benefits. But surely one of the most tragic injuries is when retirees, their spouses, and surviving spouses lose through bankruptcy their health insurance, just at a time when it is most needed in their life. These are citizens who spent a lifetime working in hard and dangerous jobs to earn what was supposed to be a lifetime employer-paid retiree insurance, only to lose it all as a result of the bankruptcy. If bankruptcy law is to be seen as legitimate and credible, it must be as humane and fair as possible on this particular subject. Therefore, when bankrupt companies sell its assets to a buyer, the buyer should fund or support at least a portion of the previous health care promises. I know Senators Leahy and Durbin and Rockefeller have each developed ideas that would dedicate a greater share of the bankruptcy estate to the needs of retirees who lost their health care in bankruptcy.

Second is the subject of pensions. Even with a comprehensive Federal pension law such as the PBGC, bankruptcies leave behind too many victims. The shock and nightmare of workers and retirees losing a substantial amount of a pension benefit because of the termination of the plans in bankruptcy is a tragedy I have witnessed all too often.

Third, the bill before you proposes to raise the priority for wages from 90 days before filing up to a maximum of $4,925. A new rule would give priority to those items earned in the 180 days prior to filing up to a maximum of $10,000. This is progress, but it is not a complete solution. For example, courts in most areas of the country view severance pay as being earned over a long period of time, often over somebody's entire career. So even a rule prioritizing 180 days' worth of accrual brings very little severance pay to the pri-

ority category. In short, there are really two problems with the wage priority provision, both the amount and accrual period.

Fourth, a section of this bill which does not appear until page 495 of a 501-page document is entitled "Preventing Corporate Bankruptcy Abuse." I believe a more comprehensive approach to the problem of corporate abuses could be addressed by eliminating or restricting key employee retention plans. These golden parachutes are payable to executives of a reorganizing company and rewarding them handsomely often after they have cut workers' pay, reduced or eliminated retiree benefits, shuttered plants, and sold them off. A second area of concern is the problem of enormous sums of money going to bankruptcy professionals. Congress should look at restricting that.

Finally, let me conclude by saying our union is committed to work with anybody in this Committee in particular on any issues over bankruptcy, and we thank you for your time today.

[The prepared statement of Mr. McCall appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. McCall.

Our final witness on the panel is Mr. Michael Menzies, who appears here today on behalf of the Independent Community Bankers of America. He is President and CEO of the Easton Bank of Easton, Maryland, has his bachelor's degree from Randolph Macon College, master's degree from Baltimore Loyola College, and moved to the Darden School of Banking at UVA.

Thank you for joining us, Mr. Menzies, and the floor is yours.

STATEMENT OF R. MICHAEL MENZIES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, EASTON BANK AND TRUST COMPANY, EASTON, MARYLAND, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. MENZIES. Mr. Chairman, thank you. It is an honor to be in front of you today and to testify on behalf of the ICBA, the Independent Community Bankers of America, and I am especially honored that you waited for my testimony.

Mr. Chairman, ICBA strongly supports S. 256 and appreciates the very hard work of this Committee over the past 8 years. We know you have truly been into this subject.

Before sharing thoughts about the environment of personal bankruptcy and its impact on our communities, allow me to offer a brief illustration of the loan risk-taking process. Community banks are in the risk-taking business, and the reward for that risk, if properly underwritten, is earnings for all concerned. The customer benefits through financial health. The healthier the customer, the healthier the community, the healthier the bank, the healthier our overall economy, the healthier our tax base. The underwriting of consumer loan risk is a fundamental driver to all local economies.

Successful consumer lending depends on numbers. Banks must make many loans to as many people as possible to diversify exposure and to spread the risk. In some respects, it is almost like health insurance without the impediments of health insurance. Consumer lending involves spreading risk over an entire portfolio. Many small loans are made, so profits from any one loan are small and profits come through volume. At the same time losses can be

significant relative to unit profitability. This is especially true when the entire principal of a loan is lost all at once. Let me review the simplified consumer loan portfolio example that is attached to my testimony.

The example consists of two revolving loan portfolios, each containing 100 loans of $1,000 apiece and each paid off within a year. One portfolio has an interest rate of 5 percent, the other portfolio an interest rate of 18 percent.

If one loan in the 5-percent portfolio were to immediately default, regardless of reason, it would take the interest payments of 41 performing loans to compensate for that default. To put it another way, if you are earning 5 percent on a loan and you lose 100 percent of the principal balance of that loan, it takes 20 years of the same loan of interest earnings to offset the loss of that one loan.

If one loan in the 18-percent portfolio defaults, it takes the interest from 12 performing loans to compensate for that default. Obviously, if a lender is experiencing greater losses than anticipated, they either have to charge more or be more selective in their underwriting process.

There is not much more to underwriting than that, but it is difficult and lenders expend a tremendous amount of effort and energy to try to get it right. A lender that provides the greatest number of borrowers with the best rate while keeping defaults to a minimum is going to have the most reward and the most customers. Anything that enhances this process has obvious consumer benefits. Anything that detracts has obvious downsides. Again, we either have to raise rates or tighten loan standards.

ICBA believes that bankruptcy is an appropriate solution for individuals who have legitimate reasons to walk away from their obligations. ICBA recognizes that all other borrowers pay for these losses created by those who are discharged from their debts. Sometimes these other borrowers are our children who inherit the impact of the cost of our credit system. This tax on the majority of individual borrowers should be mitigated wherever possible. Healthy consumer borrowers benefit communities, their economies, and our overall tax base. Economic disincentives such as unnecessary bankruptcies or the unnecessary discharge of debt hinders the wealth formation process that is necessary for social progress.

Unbalanced bankruptcy policies have significant social implications, whether manifested in the casual avoidance of domestic support obligations, State taxes, or debts owed to lenders. A balanced policy will recognize that there are situations where it is appropriate to relieve individuals of all or part of their financial responsibilities, but at the same time will encourage Americans to take ownership of their personal financial health.

ICBA would like again to express our strong support for S. 256 and appreciate the efforts of this Committee to provide a modern legal framework for bankruptcy. We hope that after 8 years of extensive consideration the Committee will move expeditiously to enact this much needed legislation. On behalf of community bankers, we stand ready to do everything possible to help you with this effort

Thank you, Mr. Chairman.

[The prepared statement of Mr. Menzies appears as a submission for the record.]

Chairman SPECTER. Thank you very much, Mr. Menzies.

On behalf of Senator Grassley, we will introduce his statement into the record in full, and Senator Grassley would also like to submit the testimony of the National Association of Federal Credit Unions and a letter from the Department of Justice, all of which will be made a part of the record, without objection.

As I had commented earlier, I am going to be due on the floor on the class action bill at 11:30, so I am going to defer my round of questioning and absent myself for just a few minutes. I think we have time for 7-minute rounds. There is a vote scheduled at 12:30, so we will have at least time for one round, and if there are other questions, we will give the members full opportunity to question as they see fit on into the afternoon.

At this time I will yield to my colleague, Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman. I appreciate your leadership on this issue. I know I have inherited Senator Grassley's Court Subcommittee, and he is the leader on this bill and has worked on it I guess for 8 years. It has been a big part of what I have done since I have been in the Senate. Former Chairman Hatch has worked on it very, very hard, and we have got a lot of bipartisan support, really.

I think there is a real consensus that we can do better, that we as a Congress ought to evaluate this Federal court system. This is not like a State court system. It is a Federal system, and we have the responsibility to examine what is happening with it, see if it is working, and where it is not working to fix it.

We have run into a lot of examples of abuses. Mr. Bennett, I think we had a little fuss over the housing matter last time, and rentals, but I think we really came up with compromise language that made a big step forward, because that bankruptcy law is clearly being abused when it comes to tenants whose leases expire, they have no right to be in there, and it just creates a nightmare.

Mr. BENNETT. Thank you so much.

Senator SESSIONS. Mr. Strauss, there is no doubt—I am so glad you made that passionately clear—that this legislation clearly benefits child support and those who are receiving alimony from the courts. That is something that has been handicapped by the bankruptcy laws, and we know we can do better about it. I personally believe and I think most Americans believe that if someone is making more than median income and can pay back a part of the debts that they owe, why don't they do so?

And I believe, Mr. Zywicki, you indicate that 80 percent of the filers in bankruptcy court are below median income. Is that correct?

Mr. ZYWICKI. That is correct, Senator.

Senator SESSIONS. And so the only people that would be impacted by the means test would be those who make median income or above, and many of those have substantial incomes. Is that correct?

Mr. ZYWICKI. That is correct, Senator, and they have substantial expenses that they can deduct, such as medical expenses, for instance.

Senator SESSIONS. Well, explain that. I know there has been some concern that somehow the medical expenses invalidate the bankruptcy reform bill. I will just put it that way. I see Dr. Tom Coburn here. Earlier he had to leave. But maybe someday if you can afford to pay the doctor or your hospital, maybe you should pay them. It is not as if they are evil entities, your physician or your hospital. If a person has a high income, they have got a low medical bill, maybe they can pay all or part of that. If they are below median income, they would not be required to pay it in any case, I assume.

But would you comment on the discussion about health care.

Mr. ZYWICKI. Thank you, Senator. With respect to your specific observations, those are exactly right. First, the way the means test works, you first have to determine whether a debtor is above the median income adjusted for family size. If not, then the means test completely does not apply.

If they are above the median income, you then move to the second step, which is to determine—to establish a budget for the debtor to live on and several categories of expenses that are permissible and are subtracted right off the top before you determine these sorts of things, one of which is specifically medical expenses. There is a specific provision in the legislation on the means test that specifically makes a special allowance for health insurance and health care expenses and for caring for other health care expenses that arise in the family.

Senator SESSIONS. In other words, if you moved into Chapter 13 and the court evaluates how much money you should pay toward the debts you lawfully incurred before you filed bankruptcy, they would consider what your required health care payments would be before they would order you to pay anything.

Mr. ZYWICKI. That is absolutely correct, Senator.

Senator SESSIONS. If they are really high, you may not be required to pay anything because the court would give you credit, so to speak, for those extraordinary health care expenses.

Mr. ZYWICKI. That is exactly right, Senator, yes.

Senator SESSIONS. Well, I think that is important.

Mr. Beine, you represent credit unions. You have members. You are a non-profit. But you heard Mr. Menzies suggest that the problem of raising costs for people who balance their checkbook and pay their debts every month when people manipulate the bankruptcy system. And you cited a young couple that clearly abused the system. Your credit union took the hit for that, as I understand it. Does that, in effect, cause you to raise rates on people who do not abuse the system?

Mr. BEINE. In the end, yes. We have implemented risk-based lending, and we apply rates based on people's credit history. And individuals who are in that category end up paying more because their fellow consumers have walked away from something. We all pay for that.

Senator SESSIONS. There is no free lunch on it.

Mr. BEINE. There is no free lunch.

Senator SESSIONS. [Presiding.] I will just conclude by noting that this bill has really had a lot of intensive interest. It has been passed four times by both Houses of Congress. That is stunning,

really, four times by both Houses. It had broad bipartisan support. In 1998, we passed a bill in the Senate 97–1. March 15th it was 83–15. I think the need has continued to grow. The problems with abuses continue to grow. I believe the means test is a legitimate factor that will involve only a small percentage of people who file bankruptcy, and those would have the chance to show that they cannot pay back anything if they have extraordinary expenses that the court could take into consideration.

We have made some progress, I think, on cram-down. We have made some progress on rental difficulties. We have made progress on quite a number of issues that have been hotly contested and debated. And generally we have ended up with real strong support across the aisle for the final bill.

So I would now recognize our next member, which would be Senator Kennedy. I will recognize you on behalf of the Chairman.

Senator KENNEDY. Thank you very much, Mr. Chairman.

I would ask, Professor Warren, would you care to comment on what Professor Zywicki mentioned in terms of the bills in medicine.

Ms. WARREN. Yes, Senator, I would be glad to. Indeed, I hope that what this colloquy means is that this Committee will consider adopting a safe harbor so that no family that has an income below the median will be required to go through all of the steps and all of the expenses in the means test that are currently imposed even when it is clear from the first minute of the petition's being filed that this person would not be someone who should be—who would ultimately be forced to pay under the means test.

As I recall, people have asked for that over and over, and it is a reminder that it is costs that matter to families whose median income is $25,000. Being forced to file the papers, go through and run the risk of the traps and tricks are a real problem.

I also hope that what this means is that there will be an amendment that will say that every family, when going through the means test, whether they currently have health insurance or not, will be permitted an allowance for health insurance. If that is the case, it would go a long way toward ameliorating some of these problems. As I understand it, it does not currently do that.

But I would also point out, Senator, as I said before, this is one of 217 sections in the bill, the means test. Every other section in this bill applies regardless of income and regardless of the reason that you file for bankruptcy. I cannot fathom why a family that has high medical bills would not be permitted to file a Chapter 13 repayment plan in a last chance to try to save their homes because they could not come up with more money for car lenders, which is what is currently required under the bill, or more money for appliance lenders.

This bill is grinding everyone through, and everyone has gotten their nose in for a piece here and a piece there. The only ones who are not represented in this conversation are the 3.9 million Americans every year who are affected by this bill, the ones who file, the ones who are the children and other dependents of those who file.

Senator KENNEDY. Yesterday you appeared at a press conference where they had three individuals who were all workers and who had been devastated by the health bills. And in that conference, you referenced a rather detailed study that you had done about

what these people had actually gone through in order to avoid bankruptcy. Could you summarize that for us, please?

Ms. WARREN. Yes, Senator Kennedy. If we could have the chart?

We asked families, we did both surveys when they first filed for bankruptcy, written surveys. We examined their court records, and then we did extended telephone interviews with these families after bankruptcy.

These families told us that before they filed for bankruptcy—these were the medical bankrupts, the people who filed in the aftermath of a serious medical problem, a million adults every year. Sixty-one percent did not receive needed medical care because they didn't have the money. They were spending their money trying to pay other bills.

Fifty percent did not have prescriptions filled that their doctors had given to them because they did not have the money and they were trying to find a way to make ends meet.

Thirty percent had worked so hard at not paying the electric bill, the gas bill, in order to try to meet their medical obligations that they suffered utility shut-offs; that is, they had the power turned off, they lost their telephones.

And among a group of people who are middle class, people who went to college, got decent jobs, played by the rules, got health insurance, as they spun out of financial control, in trouble, 22 percent went without food because they had not enough money.

And the last group that we identified here, 7 percent of the households who filed for bankruptcy moved an elderly parent to cheaper facilities in order to try to be able to meet their bills.

Professor Zywicki is certain that these people have abused the system. All I know to do is to let them speak for themselves, to bring their stories here. We have done the research. These families have tried their best. Bankruptcy was not their first option. It was not their second option. It was not their tenth option.

They told us stories about crying at the hearing, military people who had to be excused from the hearing because they cried so hard they could not talk any longer.

There are people who abuse the system. There is no doubt about it. But that is not what is happening to most of the people who file for bankruptcy.

Senator KENNEDY. Why doesn't the means test protect those?

Ms. WARREN. Senator, the means test just forces every single family, regardless of income, regardless of the reason that they filed for bankruptcy, to file new papers, to run new trips, to run new traps, ways to get them forced out of the system. It increases the cost for the attorney. It forces every attorney to take on new liability responsibilities, and that drives up filing fees for these families. There are 100 ways to squeeze the people among us who have been most desperately hurt by a broken health care system.

Senator KENNEDY. My time is up.

Senator SESSIONS. Professor Zywicki, I think I will give you a chance to briefly respond to her mention of your name. You did not suggest that everybody was abusing, did you? Or what percentage did you suggest may be abusing the system?

Mr. ZYWICKI. Absolutely not, Senator. First, the FBI estimate is that roughly 10 percent of bankruptcy petitions contain some sort

of fraud. Empirical evidence tends to suggest that 7 to 10 percent of bankruptcy filers would qualify for the means test. And if I could add one final footnote, I would refer—

Senator SESSIONS. Repeat that now.

Mr. ZYWICKI. Roughly 7 to 10 percent of the highest-income filers would be the ones who are affected by the means test.

Senator SESSIONS. It would be less—

Senator BIDEN. Could I ask for clarification? Only 7 to 10 percent?

Mr. ZYWICKI. Yes, Senator.

Senator BIDEN. Would be affected by this, is that what you are saying?

Mr. ZYWICKI. The estimates are that roughly 7 to 10 percent of bankruptcy filers today would qualify for the means test and file Chapter 13 rather than Chapter 7. However, because the means test captures and targets the highest-income debtors with the greatest repayment capacity in the system, the people who are making $80,000, $90,000, $100,000, $120,000 a year, it is estimated that recoveries from those debtors would be roughly—that they could pay roughly 60 to 70 percent of their unsecured debt in bankruptcy. And I think there are two notes to be made about as it relates to this.

First, with respect to the means test, the allowances, as I said, are subtracted. I would also refer the Committee to Section 102(i), which is labeled special allowance for health insurance, and I believe Professor Warren said that there should be a special carve-out for health insurance payments. Section 102(i) is exactly that.

Finally, I think that it is worth considering and I think that it is worth—the idea of whether or not we truly believe that medical providers should be treated as second-class citizens in bankruptcy, that just because a doctor delivers a baby or your neighborhood drug store sells you prescription drugs, the idea that they should not be entitled to the benefit of the means test for people who could repay their debts I think is troubling.

Senator SESSIONS. Well, thank you. We do not want to get too far off base. But I think Senator Biden and maybe others would like to ask discreetly, just briefly. I had been using the figure that only about 20 percent of the people would qualify for the means test. Where do you get the numbers that now say 7?

Mr. ZYWICKI. Certainly, Senator. I apologize for the ambiguity. The means test has two steps. At the first step, which is do you make above the median income, 80 percent of debtors make below the median income. That means 20 percent of filers move on to the second step. The estimates are that at the second step, you would determine that a number of the people who make above the median income would not have substantial repayment capacity after you subtract all of the allowances that are allowed by the means test. So after you subtract medical expenses, that sort of thing—

Senator SESSIONS. Well, we better get back to regular order.

Mr. ZYWICKI. And so roughly 10 percent are left over after you jump both of those hurdles.

Senator SESSIONS. Senator Cornyn?

Senator CORNYN. Thank you, Mr. Chairman.

I want to express my appreciation to Chairman Specter, but also to Senator Biden and Senator Grassley for all the hard work they have done on this, long before people like me even came to the Senate. And I know this has been long in the process.

I support bankruptcy reform because I think we need to restore a greater sense of personal responsibility to our financial system and prevent the abuses of the bankruptcy law that we have witnessed in recent years. Bankruptcy relief should be available to those who are unable to pay, not to those who are simply unwilling to pay.

I would like to focus my comments and questions, though, on some new legislation that I filed earlier this week called the Fairness in Bankruptcy Litigation Act of 2005. And just by way of background for my colleagues, this arose out of an experience that I had in a previous life as Attorney General of Texas during the Enron bankruptcy.

Of course, Enron was headquartered in Houston, Texas, but lo and behold, its bankruptcy was handled by a bankruptcy court in New York, where apparently they had had a subsidiary with 57 employees, notwithstanding the fact that 7,500 employees were located in Houston, Texas, along with many of the creditors and witnesses and others, certainly the workers and the pensioners whose lives were directly affected by that bankruptcy.

The purpose of the bill that I filed was to try to prevent judge-shopping in bankruptcy. We know that sometimes the most important determination made as far as the outcome of a lawsuit can be the court in which that case is heard. It is just human nature, certainly, that the party who benefits, here the debtor, might try and find the most favorable forum. We understand that being part of human nature. But it is our job to try to make sure the playing field is as level as possible and that nobody gets an unfair advantage going in.

But I was very concerned because I saw the abuse from my perspective of the venue laws in bankruptcy in the Enron case where people in my State, my constituents were denied the opportunity for a forum that was close to home where they could actually have their claims heard and the case decided.

As I have gotten into this, I have learned that there are a lot of people concerned about the same problem. For example, there is a new book written by Professor Lopucki of UCLA, I believe, called "Courting Failure: How Competition for Big Cases Is Corrupting Bankruptcy Court." And I know that Professor Warren, who we have talked to about this, shares some of those concerns. Professor J.L. Westbrook of the University of Texas Law School and a lot of other people ranging from—well, really on both sides of the aisle; my successor, Greg Abbott, as Texas Attorney General, but also former Massachusetts Attorney General Scott Harshbarger, a Democrat, who I guess is still head of Common Cause, or maybe just immediate past.

So this is a concern shared by an awful lot of people, and I just want to ask—first I want to ask Professor Warren, first to express my appreciation for your consulting with my staff on this issue, but also then maybe to ask Professor Zywicki what your comments

might be on judge-shopping in bankruptcy and the concerns that you may have. First, Professor Warren, would you please respond?

Ms. WARREN. Yes, Senator. Thank you very much. It has been my honor to work with your office on this important issue. I do not think this is an issue of Republicans or Democrats, an issue of liberals or conservatives. It is a good government issue. And as I see it, the background system makes a promise, and that is that there will be full and fair access for everyone, every creditor, everyone who has been injured or affected by the process.

In the case of large corporations that can leave their home venue—Enron, who can leave Houston, Texas, where its employees, where its pensioners, where its trade creditors reside—and escape the obligation to make the process open to the thousands of people who are directly affected by the bankruptcy, that affects the bankruptcy system overall. A fair bankruptcy system is one that retains access for the employees, for the pensioners, for the small creditors, and that means those cases need to stay home, not go to a distant location where they think they may get a better deal.

Senator CORNYN. Well, I have been impressed by the range of people that are concerned about this, everyone from the Enron employees committee, which has endorsed this particular bill, the National Federation of Business, and it is really quite a broad range of people. But is it your impression, Professor Zywicki, that creditors and employees, pensioners and others who are forced to litigate a bankruptcy in a far-flung forum, that some of them just simply give up or perhaps the costs of litigating in that far-off forum simply exceed the value of their claim and so ultimately it benefits the debtor rather than the creditor, someone with a valid claim?

Mr. ZYWICKI. Senator Cornyn, that is probably the case, but I have not studied this particular issue closely enough to render an opinion on your piece of legislation.

Senator CORNYN. I appreciate that answer, and let me clarify. I am not asking you to endorse the legislation now, anyway. I would appreciate it if you would look at it and tell us what you think.

Mr. ZYWICKI. Certainly.

Senator CORNYN. But is it a widely recognized problem not just among legal scholars, academia, but also practicing bankruptcy lawyers, as well as debtors, creditors and others that forum-shopping, judge-shopping, if I may say, is a cancer on our bankruptcy system?

Mr. ZYWICKI. Senator Cornyn, I think there is no doubt that it substantially increases the cost to creditors and that there are a number of people, including Professor LoPucki and others, who have expressed concern for quite some time about this problem. There are others who have not seen it as quite a problem, but certainly it is the case that it makes it more difficult for creditors, employees and others to vindicate their rights in a distant forum than it would be otherwise.

Senator CORNYN. Mr. Chairman, before I relinquish the floor, let me just ask unanimous consent that letters of endorsement that we have received from a variety of scholars, practitioners and people who are vitally concerned with this issue be made part of the record.

Senator SESSIONS. They will be made a part of the record.

Senator CORNYN. Thank you very much.

Senator SESSIONS. I believe Senator Biden is next. Without objection, we will go to Senator Biden.

Senator BIDEN. Thank you very much. I will refrain from what I assure my friend from Texas will be an incredibly long fight over this amendment. I find the language that is used kind of fascinating—escape from the obligation to be open.

Is the colleague suggesting that the Delaware chancery court is not open, is somehow an unfair court? I find it outrageous such a statement. Maybe you can tell me. Is it not a competent court? Is it not an open court?

Ms. WARREN. Are you asking me, Senator?

Senator BIDEN. Well, yes. You are the one that said "escape the obligation of making the process open."

Ms. WARREN. Actually, Senator, bankruptcy cases are not heard in Delaware chancery court.

Senator BIDEN. Excuse me, in Delaware, in Delaware. Bankruptcy courts in Delaware are not open?

Ms. WARREN. They are not open to employees of companies like Enron who cannot afford—

Senator BIDEN. In what sense do you mean open?

Ms. WARREN. Excuse me, Senator?

Senator BIDEN. In what sense do you mean open? The record is not open or they can't conveniently get there?

Ms. WARREN. Employees of companies like Enron literally cannot go to Delaware and hire local counsel, which the Delaware bankruptcy court requires of them before they can make an appearance, and that effectively cuts thousands of small employees, pensioners and local trade creditors out of the bankruptcy process. If they can't afford it, they are not there.

Senator BIDEN. Can they afford it in the States in which they reside?

Ms. WARREN. In the States that they reside in, they have local counsel, and local counsel can go down the block and appear on their behalf.

Senator BIDEN. No, but can they afford it in those States?

Ms. WARREN. Yes, and they do and they appear.

Senator BIDEN. Well, I only have seven minutes and I should talk about the Bankruptcy Act that is before us because this is a proposed additional law and there will be plenty of time to debate it.

Let me ask a couple of questions here. By the way, this did start 8 years ago, this legislation, but there have been numerous changes to it in 8 years. Eight years ago, the person who stopped its passage was me because it did not have a safe harbor in it, it did not put women and children at the front of the line, it did not do a whole range of things that subsequently have occurred. We relitigated this 2 years ago, not in this Committee, but on the floor of the Senate, in conference, and we did it in great detail.

I would ask unanimous consent that a statement that I have, Mr. Chairman, be entered for the record, if I may, at this point.

Senator SESSIONS. Without objection.

[The prepared statement of Senator Biden appears as a submission for the record.]

Senator BIDEN. I think one of the very important amendments that should be added to this legislation is the Schumer amendment, which, in fact, was part of the legislation, was part of an agreement that was crafted between the House and the Senate, and was part of what passed out of here as part of the bill overwhelmingly. The numbers that the Chairman cited—87, 88, 89 votes, whatever the numbers were the several times it was passed out—contain the Schumer amendment.

I am confused about one thing here. There is no question, coming from a family that has been, unfortunately, an excessive consumer of medical health care expenses, how someone can be absolutely crippled by these medical expenses. There is no question about that, in my view.

What I have difficulty trying to figure out is should the irresponsibility of the Federal Government and the State government be thrust upon the creditor. Let me move away from health care for just a moment. There are an awful lot of people in the National Guard right now who are being sent overseas. They have jobs where their combined income of the husband and wife may be $80, $90,000 a year, but the male or female who is sent overseas, called up by the National Guard or the Reserves, who maybe was making $60,000 a year is now, based on their rank, making $24,000 a year. They have the same car payments, they have the same house payments, they have the same tuition payments, they have the same bills.

My question is if they cannot pay those bills because of an extended tour, which many are going through, and they have to declare bankruptcy, should the creditors who have lent money to them based upon their initial income—should they be the ones that pay the cost, in effect, of their inability to pay, or is that a larger responsibility of the public at large?

That is what confuses me about your arguments, Professor Warren. They are very compelling, they are literally true, but in a sense they beg the question. It seems to me that the Federal Government should be seeing to it that every American is put in a position where their health care costs are such that if, in fact, they have these extraordinary expenses, it is the social responsibility of the community to help them, as opposed to the social responsibility of the particular doctor or the particular bank that lent the money or the particular creditor who has put forward money, assuming there was any ability to pay.

Just a philosophic question: should anyone who has extraordinary medical expenses that unquestionably exist—should they be able to say, when there is an inability to pay all other bills, whatever they are—I mean, if they were going to pay those medical expenses, they wouldn't be able to pay another bill, from the gas company to whoever. Is it a societal requirement we should write into the Bankruptcy Code that says that the gas company should subsidize the payment of those medical bills, that the local drugstore should subsidize the payment of those medical bills?

Maybe we should. I am being deadly earnest here, because you make a very compelling and mildly demagogic argument that talks about what is true. All of these things are true, and so my question is, from a philosophic standpoint, is it the responsibility of the gas

company and the drugstore and whoever else you named to make sure that these people do not have to make these hard choices, or is that a responsibility of the Government or the people at large? That is my only question I will ask, and I am asking you, Professor.

Ms. WARREN. Senator, I think you have put your finger on the heart of what the bankruptcy bill—or bankruptcy, in general, not this bill—

Senator BIDEN. No. Forget bankruptcy. I am asking a larger question. Forget about bankruptcy.

Ms. WARREN. But that is what I mean. It is the question of what role bankruptcy plays—

Senator BIDEN. That is not my question. I would like you to answer my question. What role is there under what you would consider to be an appropriate form of Government where we legislate? Do we say that people who, in good faith, provide a service for an individual that the individual is later unable to meet because of a legitimately horrific and extraordinary dilemma that was an act of God—who should be responsible for taking them out from under that crushing burden?

Should it be the automobile company who lent the money to purchase a car, the drugstore that provided a service and, in effect, lent the money because there is a bill, the drug bill, the utility company, the guy who has the lawn service company? Whose responsibility is it? That is really the question, because if you buy into this argument, which is very compelling, in my view, you are saying the creditors should be the ones to buy into that philosophically, enshrined in a piece of legislation obligation. That is my question.

Ms. WARREN. Senator, I think you are exactly right, and that is that we need fewer families to need to turn to the bankruptcy system. We have a broken health care finance system in the United States, and all I can do is point out that it is bankrupting families.

Senator BIDEN. Absolutely right.

Ms. WARREN. Until we fix the broken health care finance system, those families have to turn somewhere and that means now they turn as a last-ditch effort to the bankruptcy courts.

Senator BIDEN. And that means they turn to asking the people that they borrowed money from to pay for their health care costs, right?

Ms. WARREN. Senator, the costs—

Senator BIDEN. Isn't that literally correct?

Ms. WARREN. It is literally correct that the costs of a broken health care system are borne throughout the economy.

Senator BIDEN. We are asking—and I may be ready to do this. We are going to ask the gas company, the drugstore, the automobile dealer to pay for the broken system instead of having the nerve to come and say it is a moral obligation of a nation to pay for that broken system.

Why should it not be someone who sits there, living in a $2 million home, who lent no money to that person—why do they not have an obligation to pay for that instead of the guy who owns the drugstore at the corner pay for that? That is my only point. Let's just be honest about what we are doing here. It may make sense.

I would like to put in the record a Forbes article, and I would like to ask you whether it is an accurate quote, Professor. They quote you in an article entitled "Everybody Knows It's Credit" in Forbes magazine saying, quote, "The lobbyists are going to be the only ones who really profit, scoffs Elizabeth Warren, Harvard Law professor." I think you are dead right because as you point out in here, we have to find new bogeymen. The people who aren't going to benefit under this are the credit card companies, as you point out in here.

I submit this for the record, if I may.

Chairman SPECTER. Without objection.

Senator BIDEN. I would invite any response in writing from anyone who would like to respond to the article. We will make it available to you.

But I just think we should be honest about this thing. Making the gas company—and I don't like the gas company. I don't like many companies, but at any rate, we just ought to acknowledge what we are doing here when we make these kinds of assertions.

Chairman SPECTER. Thank you, Senator Biden.

Senator KENNEDY. Can Professor Warren just respond to the quote? Do you want to just respond to the quote?

Ms. WARREN. I think the Senator makes an entirely fair point about externalizing the costs and I would add only one caveat to it. Not only does this bill treat all debtors alike. In many ways, it treats all creditors alike. The gas company doesn't have the capacity to change its pricing to reflect these risks, or has very limited capacity. But I remind you of what the credit card companies have already—

Senator BIDEN. Should it? That applies they should.

Ms. WARREN. No.

Senator BIDEN. Should the gas company be required to change their prices to reflect these—

Ms. WARREN. No. Of course, they shouldn't, Senator.

Senator BIDEN. The way you stated it, you said they don't have the capacity. The implication is maybe they should have that capacity.

Ms. WARREN. No. My point is the losses will go to some creditors who cannot reflect this in their prices. But look at the cases cited in my testimony where credit card companies—I have a specific case, In re McCarthy, but nothing unusual about it, a woman who borrowed $2,200. She paid back $2,100 over the 2 years preceding bankruptcy, and at the end of that period of time she was told she still owed $2,600.

With fees and interest, I submit, Senator, that there are many in the credit industry right now who are getting their bankruptcies prepaid; that is, they have squeezed enough out of these families in interest and fees and payments that never paid down principle.

Senator BIDEN. Maybe we should talk about usury rates, then. Maybe that is what we should be talking about, not bankruptcy.

Ms. WARREN. Senator, I will be the first. Invite me.

Senator BIDEN. I know you will, but let's call a spade a spade. Your problem with credit card companies is usury rates from your position. It is not about the bankruptcy bill.

Ms. WARREN. But, Senator, if you are not going to fix that problem, you can't take away the last shred or protection from these families.

Senator BIDEN. I got it, okay. You are very good, Professor.

[Laughter.]

Chairman SPECTER. Thank you very much, Senator Biden.

I am advised that Senator Kennedy has questioned, so we have four more Senators to question. The vote is scheduled at 12:30, which is 30 minutes from now, so we have time for 7-minute rounds if we observe the limits. I will take my seven minutes now.

Senator BIDEN. May I be excused, Mr. Chairman? I am going to another tsunami hearing.

Chairman SPECTER. We will miss you.

Professor Warren, you testified in the opening comments about new problems such as the Enron executive problem. What would your suggestion be as to how the bill ought to be modified to deal with that issue?

Ms. WARREN. Senator, I think that Senator Durbin had a series of amendments proposed, I believe it has been 2 years ago now, that tried to address that directly, the notion that the bankruptcy courts need to be much more scrupulous about executive compensation and about insiders who take money out during the course of a Chapter 11, particularly when the consequence is to leave nothing for their employees, their pensioners, their health care plans. I think there is actually already drafted potential legislation here, sir.

Chairman SPECTER. Mr. Strauss, you have emphasized the support orders as being a priority item. Would you have any suggestions as to how this bill might be made stronger to provide for support?

I think there is a decided public policy in favor of seeing to it that those who owe support for children pay it and don't leave children in the hands of the mothers, absconding. What suggestions, if any, would you have to make the bill stronger on that important item?

Mr. STRAUSS. I had actually in the last go-around suggested another exception to the automatic stay. The Federal Government requires that when a debtor is not paying support, his passport be taken. That was not included in this, so I would—it is a minor addition, but I think it would be helpful in enforcing child support obligations to remove from the effects of the automatic stay the right of the Government to withhold passports. Other ones are so technical it would just really take me too long to explain.

Chairman SPECTER. Mr. Bennett, I note that you are the founder of the Minority Apartment Owners Association. Do you think that this bankruptcy bill fairly treats minorities, or would you have any suggestions on that line?

Mr. BENNETT. Well, as the study reports, the majority of small properties are owned by individuals, some 47 percent. So it really adversely affects not only the minorities, but the smaller property owners. Whereas most people have a belief that all apartments are owned by big conglomerates and REETs and things like that, the study shows that 47 percent are owned by individuals just like myself. So we certainly are adversely affected by bankruptcies.

And not only that, but I pointed out in my testimony that we have cases where we have multiple bankruptcy filings where the husband will file and then the wife will file, and then we turn around and we have an 18-year-old son on their file. We have even had to request in some cases that the judge put on their order "no additional bankruptcy filing." So it is a real concern.

Chairman SPECTER. Mr. McCall, bankruptcies have certainly taken a very heavy toll on the economy and a very heavy toll on loss of jobs. The steel industry has been beset by quite a number of problems. The imports—we have done a little good on that. United States Steel Corporation has made profits in the last year and I think we are doing better, although more recently we have had a surge.

I would be interested in your thinking on the asbestos problem which has caused some 74 bankruptcies and the tremendous loss of jobs in America. To what extent has that impacted on the interests of the labor movement?

Mr. MCCALL. Certainly, it is a very similar situation and related to the health care issues that we were talking about earlier. There comes a point in time where companies by their creditors are loaned money, and whether or not they are doing responsible things with that money, whether or not they are investing that money responsibly, whether or not there are overpayments to executives, and even then once bankruptcy is initiated, whether there is a planned reorganization and the company reemerges paying part of that debt or whether they spend a vast majority of that money on professional professionals in bankruptcy, or whether they spend a great deal of money on, as I said before, KERPs and incentive plans for executives to downsize and downsize and downsize, leaving no jobs available, leaving no health care for the workers. So I think it is similar and related to the health care issue.

There are probably other issues that enter into the Bankruptcy Code and issues of responsibility and fairness and justice and equity for all of the stakeholders in a company that is entering bankruptcy.

Chairman SPECTER. Professor Zywicki, would you be able to expand on what Ms. Vullo testified? She had to leave before the question-and-answer session. She testified, as you heard, about going through a large series of efforts to enforce judgments. Does your expertise extend to that field to give some guidance to the Committee as to what we might do to avoid the kind of a problem she articulated?

Mr. ZYWICKI. Senator, I have not in the context of preparing for today's hearing studied the specific language which has been proposed in the past because it is not part of this bill. What she reflects is, of course, similar to what all creditors go through in the current bankruptcy system, which is the difficulty of trying to collect debts. With respect to the particular amendment that she has proposed, I would have to study the language more specifically before I could render a full opinion on it.

Chairman SPECTER. Well, I am sorry she wasn't able to stay longer. I intend to telephone her to get some more specification as to what she had to say. It sounded like a long chase. We have had the inability to complete this bill because of the provisions relating

to collection of judgments and avoidance through bankruptcy by those who have judgments against them under the abortion laws. So we will be pursuing that.

Well, I have four seconds left and I will terminate on time and yield now to Senator Feinstein.

Senator FEINSTEIN. Thanks very much, Mr. Chairman. I neglected to introduce the two participants from California, and so I would like to acknowledge Mr. Bennett and Mr. Strauss' participation. It is a long way from California, as they say, so we are delighted to have your testimony today. Thank you so much.

I think Dr. Warren's op ed piece that says that almost 50 percent of bankruptcy petitioners have health care problems is really something that we need to take into consideration. In the last Congress, the 107th Congress, I proposed an extreme hardship amendment, and essentially what it did was provide a rebuttable presumption.

I would like to just read to the panel part of this because if you take one of Mr. McCall's, for example, union members, and because someone close to me is going through this right now, just to get a cancer diagnosis can run over $100,000 in tests. It is possible to have a health problem and you are never able to repay the debt. Therefore, the question comes whether this kind of debtor really should be pushed into Chapter 13 or remain in Chapter 7. So we proposed this last time. It went down, but I would like to work on it for the markup for this Committee, and let me read it to you.

"In addition to the other grounds by which presumption of abuse may be rebutted under this subparagraph, the debtor may rebut the presumption by showing that the debtor's financial problems are the result of extreme hardship and extraordinary circumstances beyond the control or reasonable expectation of the debtor for which the debtor should not be held justly accountable. If there is another ground by which the presumption may be rebutted, this clause shall not be construed to require a finding of abuse if the debtor's financial troubles arose from circumstances that were either within the debtor's control or for which the debtor should be held accountable."

I don't know whether this is perfect or not, but it seems to me that to push somebody into Chapter 13 and require that they repay a debt for which they bear no personal responsibility and have encountered an extraordinary and extreme hardship is not something that we should do, particularly as medical costs go up.

I was told last week that the cost of one use of certain machines is $3 to $4,000 for diagnosis. Well, if you are on Social Security or if you are one of Mr. McCall's union members or if you are the average for my State, there are health care costs which you can never repay. It is just impossible.

Now, Senator Biden's theory is, well, the Government should do that. That is not this bill. I don't really want to get into that, but it seems to me that there are some bona fide situations in which a debtor facing this kind of unavoidable and extreme hardship should not be pushed into Chapter 13.

I would like the panel's response.

Ms. WARREN. Professor Zywicki, would you like to go first?

Mr. ZYWICKI. Senator, I understand what you are saying. I would urge this Committee caution with respect to the premise, which is

with respect to the conclusion that half of bankruptcies are substantially caused by health care. I have reviewed the study on which that is based. That number is substantially larger than any other study that has ever been done with respect to the relationship. The authors of the study consider a serious health care problem to be anything more than $1,000 in health care expenses over some period of time.

Senator FEINSTEIN. But that is not what I am saying. I mean, I am not talking about a study. I am saying we all know that health care costs can bankrupt you.

Mr. ZYWICKI. Absolutely, yes.

Senator FEINSTEIN. The question is whether you have the possibility in your lifetime of repaying these costs.

Mr. ZYWICKI. Senator, I believe that it is appropriate that the same rules should apply to everybody, which is if you can repay some or all of your debt, whatever it is, whether it is 20 percent, I think that is appropriate. I think, secondly, the bill as it is written takes account of health care problems, health care expenses and that sort of thing. So I think that with respect to the problem we are trying to deal with, the bill is adequate as it currently stands to deal with the problem.

Senator FEINSTEIN. Anybody else? Dr. Warren.

Ms. WARREN. Thank you, Senator. I think, Senator, you have put your finger exactly on the key point, and I think, with respect, Professor Zywicki has given exactly the other side. He doesn't care what happened to these families or why it happened. The only question is you put them in, you turn the crank, and if it is possible to use public dollars to squeeze some more pennies out of them on behalf of their creditors, then do it.

I think you ask exactly the right question. If we are to inject morality into this system, if we are to make the hard judgments, then it is incumbent on us collectively to ask what happened. Why did these families get into trouble?

I think you are exactly right. Provide the escape, provide the safe harbor for the family who did everything right—good educations, decent jobs, paid for health insurance, got married, bought houses, aren't the abusers, the people who really wanted to play by the rules, the people who the last thing they ever wanted to do was end up in bankruptcy, but who discovered that in America today one medical diagnosis can take a solid, hard-working middle-class family and turn them upside down financially. You are offering them a chance to turn rightside up again.

Senator FEINSTEIN. Well, I would appreciate it if anyone on the panel would take a look at the language, at least. I am going to move something like this in the markup. It may well go down again, but I would appreciate any input that you could give to it.

Could I make one other point, and that is on credit cards and sending these credit cards out to children. One of the things that I tried to do in another amendment was put a limit of $2,500 per card for a minor. I would like to have your comment on that.

Mr. BEINE. Number one, we do not send out unsolicited credit card mailings. And, number two, our limit is $500 for minors.

Senator FEINSTEIN. Would you repeat that?

Mr. BEINE. At our credit union, our limit for minors is $500. We require the parent's signature. We do not give out unsolicited—

Senator FEINSTEIN. How about throughout the industry?

Mr. BEINE. I cannot speak for the industry overall.

Senator FEINSTEIN. Thank you. That is helpful.

Ms. WARREN. Senator, I would just point out that the industry now refers to minors, those under the age of 18—I was looking for the exact language, but as a growing market for them, the last group that isn't already carrying credit cards. They are a new profit center—children.

Senator FEINSTEIN. I think this is something that we need to take a look at, Mr. Chairman, and I need certainly to get updated. But I saw where 8- and 9-year-olds are getting solicitations with toys through the mail if they pick up a credit card.

Now, it seems to me that with respect to a minor, there ought to be some limit on the amount of credit, without a signature of a parent and a guarantee by the parent to repay the debt.

Chairman SPECTER. If they contract with an 8-year-old or a 9-year-old or another minor, it is unenforceable.

Senator Durbin, I believe under the early-bird rule, you were here early and you are next.

Senator DURBIN. Thank you very much, Mr. Chairman, and thank all the witnesses. Can I make a general observation, since we don't have any opening statements, about this session of Congress?

It is curious to me that this is such a high priority, that this needs to be fast-tracked, that we need to move on this bill right now and get it out, a 500-page bill. We are going to have two hours-and-a-half, we are going to discuss it and we are going to mark it up next week. That is my understanding.

As we look at the witnesses at the table, there are so many people not there. Where is the credit card industry? I will you in the back rows. Don't hold up your hands, but you are not at the table. Yet, you are the big player and the big push behind this bill for a decade. Ten years, you have been begging for this bill to preserve credit card debt through bankruptcy. Yet, you won't come up and testify.

I don't understand that, Mr. Chairman, why the most important industry behind this bill will not have the courage to step forward and explain why they want this bill. It tells us a lot.

I think as you listen to the testimony here from the witnesses, you come to understand that the face of bankruptcy is a lot different than the industry describes it. Professor Warren has told you what she has found. Professor Zywicki, a visiting professor at my Georgetown Law School, may see it otherwise. But I happen to believe Professor Warren is closer to the truth because, Mr. McCall, I know your steel workers and I know what has happened to them.

I can tell you in the State of Illinois, in southern Illinois, that we have a coal miner with emphysema, worked his whole life in the coal mine, did everything right, retired early because of his illness, and then the Horizon Mining Company went into bankruptcy and canceled his health care. The man is hoping that he will get enough health care to live until he reaches Medicare. If he doesn't, he will be facing bankruptcy.

I don't think he is morally flawed, Professor Zywicki. I think he is a man who, because of misfortune, has no other choice. And I hope that as you acknowledge 7 percent of the people guilty of fraud and abuse in bankruptcy, if it is that number, that you will acknowledge that a much greater number come into bankruptcy under the circumstances Professor Warren has described, not because they want to, in the hopes that they don't have to and want to get out of it.

Professor Warren, on that earlier comment about 7 percent fraud and abuse, would you reflect on that?

Ms. WARREN. As I understand this, it does not come out of any study. It is the FBI's estimate, as I understand it, of how many people have mistakes in their forms. People make mistakes. These are people whose median income in the year before filing is $25,000. These are people for whom two out of three have lost their jobs. These are people half of whom have had serious health crises and they don't always get every number right. There is no doubt about that. Should they? Yes, sir, but to refer to this as a system that has 7 percent abuse in it—there is simply no evidence of that.

Senator DURBIN. I would just say I think it is nothing short of an outrage that we are not looking at the corporate bankruptcies that are stripping away health care retiree benefits, pension benefits and contract agreements that people have lived by for a lifetime. We are not even considering that. We are talking about the victims of that process and how to make life more difficult for them. That is what this hearing is about. That is what this bill is about.

Why aren't we talking about that, and why won't we spend 5 minutes talking about health care in America, for goodness sake, this looming crisis in America that no one will address? It is hitting businesses and families and individuals, and now the victims of that crisis that we won't even talk about are the ones who are going to be disadvantaged again.

Professor Warren, will you try to bring this into a context that is very important for this conversation? The argument is that if you are below median income, why are you worried about this means test? It is not going to affect you. Why is it going to affect you if you are below median income?

Ms. WARREN. Senator, in two principal ways. The first is there is no safe harbor; that is, you are not exempt from the forms, the requirements of filing, the tricks, the traps, the deadlines, the increased attorneys' fees in order to have someone tell what they could tell on the very first day, and that is you are not part of the means test.

If there were a safe harbor for the 80 percent of the families for whom one sheet of paper tells you they don't belong in the means test—if they were safe harbored and taken out, we would be having a very different conversation. That is part one.

But I want to say about part two it is only one section in the bill. This bill changes Chapter 13. It changes the number of places where credit card companies will get the right to threaten to object to someone's discharge, which means more often that those people will agree to pay their debts, notwithstanding bankruptcy.

There is one cut after another, provision after provision. And on whom does it fall the hardest? The families in the worst financial trouble. Be clear here, Senator. A multi-millionaire can still skate through bankruptcy, even if every provision in this bill were adopted.

Senator DURBIN. And hang on for the most embarrassing amendment on the floor when we talk about homestead exemption and tell the story of Bowie Kuhn, the former Commissioner of Baseball, who hung on to a multi-million-dollar mansion in Florida that he was able to keep through bankruptcy, and Burt Reynolds, the actor, who did the same thing. Yet, we are hammering away at people who can't pay for cancer surgery. Does this make sense?

The second point I want to make: are there as a result of this bill going to be more debts that are non-dischargeable in bankruptcy that when it is all over, despite your best efforts, you are stuck with for life?

Ms. WARREN. Yes, Senator, that is what this bill is designed to do. That is why every women's group that has looked at this bill has opposed it, because their real concern is that this forces them into competition with Citibank and Bank One when they are trying to collect from an ex-husband who has been through bankruptcy. This is the central concern.

Every single family who gets pushed out of the system because the fees are too much now, every single family who ends up with non-dischargeable debts literally will be responsible for those debts until they die. It is important to remember that for most of the families who file for bankruptcy, they don't have enough income to pay the interest. So what that means is it is like Ms. McCarthy. She can pay $2,000 a year for the rest of her life and she will die owing Providian as much as she owed them the day she filed for bankruptcy.

Senator DURBIN. And it is our highest priority to make sure we pass the bill that says that she will continue to make that payment.

Thank you.

Chairman SPECTER. Thank you, Senator Durbin.

Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman. I want to welcome our witnesses, particularly Ken Beine from Wisconsin. I am always glad when I can hear the scholarship of Professor Warren, and I also want to commend Senator Durbin's very powerful remarks.

Mr. Chairman, I appreciate your holding this hearing rather than taking this bill directly to markup this week, as was originally planned. Let me respectfully suggest that the testimony we are hearing makes it very clear that a markup of this bill in this Committee next week would be premature.

This bankruptcy bill was essentially written in 1998, seven years ago. The last time the Judiciary Committee held hearings or took any action on the bill was in early 2001. It is now 2005. It is simply inconceivable that this Committee will be ready next week to do the job that it needs to do on a bill this complex and a topic this important to our economy and the lives of many of our most vulnerable citizens.

The last significant bankruptcy reform legislation in this country was passed in 1978. This is not a topic that Congress gets back to every few years. We need to get this job done right and we need to do it comprehensively. That means addressing the important issues raised by the effect of increasing corporate bankruptcies on the pensions and health care of employees, rather than saying that those issues can wait for another bankruptcy bill sometime in the future. These are pressing issues that this Committee must face up to now, and it certainly will not be an acceptable answer to those who point out real problems with how the current bill will operate that we can somehow fix this at a later date. That is not reality.

So I hope, Mr. Chairman, that this Committee will serve its proper role in the Senate to examine legislation carefully and completely before sending it to the floor. I hope that every member of this Committee, even those who support this bill, will recognize that a real amendment process is appropriate here, in contrast to what we have seen on the class action bill over the past few weeks.

My questions today, although they will be brief, will highlight some of the problems with S. 256 that practitioners and academics and trustees have identified. We need to listen to those non-partisan experts before we enact this bankruptcy bill or we will do grave harm to a system that is a crucial part of the safety net that the law offers to our most vulnerable citizens.

Let me first turn to my friend and constituent, Mr. Beine. I wanted to especially thank you for being here. It is always good to see somebody from Wisconsin in Washington, and I wanted to say to you that I know how tough it is for everyone who has suffered from the devastation of our manufacturing sector. I know firsthand from my own visits that Two Rivers, or Trivers, as some say, and Manitowoc have been hit especially hard by this.

Wisconsin has lost tens of thousands of manufacturing jobs in the last few years, and the biggest sector of the economy by far in Two Rivers and Manitowoc is the manufacturing sector. So the whole area has been affected dramatically. In a recent study, 37 percent of businesses in Manitowoc and Two Rivers reported that they had to lay off employees in the past year. So it is not surprising for me to hear you say that there has been an increase in bankruptcy filings, although it is certainly terrible news.

There are a number of important steps Congress could be taking to help people in Manitowoc and Two Rivers, including changing our tax code to help beleaguered domestic manufacturers and rethinking international trade agreements that have been devastating for American businesses.

The problems you are facing are very real, but I want to make sure we don't pass a bill here that will actually compound the burden on Manitowoc citizens, Two Rivers citizens and Wisconsin citizens. I don't want to take any action that is going to further harm people who I know have borne the brunt of this administration's failed economic policies by undermining a law that stands between them and complete destitution.

I am a big fan of, as you know, and a friend of the credit union industry. You are wonderful people and you serve your communities very well. I think this bill is a bad deal for my constituents and your customers, so I am afraid we have to part ways on this

issue. This bill hasn't changed all that much since it was introduced 8 years ago, before the problems with the erosion of our manufacturing base became so severe. So it may not really be designed to address your problems. So I would like to give you a chance to respond to what I have said, and I would like to ask Professor Warren if she would like to comment as well.

Mr. Beine.

Mr. BEINE. First of all, thank you for the kind words. I guess I respectfully disagree with some of the statements. We are convinced that the current law hurts financial institutions because there are a number of individuals who abuse it. Under no circumstances are we looking to hurt those individuals, the 80 or 90 percent, or if it turns out to be 95, that still need the ability to be able to completely walk away and start over. The bankruptcy law is here to enable people to start over, and that is an important right in this country.

Thank you.

Senator FEINGOLD. Professor Warren.

Ms. WARREN. I would only add that I too am a big fan of credit unions. I was explaining to Mr. Beine earlier I have family members who have really relied on their credit unions to help them get past tough times, and I have cosigned more than one loan to the credit unions which were paid off in full. I want to be clear, sir.

But I really want to go back to a key point here. I think credit unions are responsible lenders who are very careful about the money they put out. I believe the thrust of this bill, by forcing more families out of bankruptcy, by driving up the costs, by making more debts non-dischargeable, is a reward to irresponsible lenders.

I believe that what happens is that good people come in, like credit unions and like small landlords, who really are affected. There are changes we could make to make things better for them. But they are here, when it is credit card companies who have behaved irresponsibly and who have already raked billions of dollars of profits off these families before they file for bankruptcy that are the real problem. If we wanted to make this bill work, part of what we would ask is how to sort out the good lenders from the bad.

Senator FEINGOLD. Thank you, Professor.

Professor Zywicki, as you know, I have mentioned that the Bankruptcy Act was first introduced 8 years ago, and you have long supported it. However, as Professor Warren has stated, the 8 years since this bill was introduced have seen many developments with significant implications for bankruptcy law. Furthermore, we now have significantly more data about who files for bankruptcy and why they do than when the bill was first introduced.

Given all the things that have changed since the original bill was drafted and given all the new information that has emerged since that time, is there anything about this bill that you think should be changed, or do you endorse S. 256 without any adjustments whatsoever?

Mr. ZYWICKI. Senator, first, let me clarify that I believe that the majority of bankruptcy filers are legitimate, honest bankruptcy filers, and I would not endorse this bill if I believed that in trying to eliminate fraud and abuse we would be harming people, the honest, innocent people for whom bankruptcy is intended.

Having said that, this bill has been around for 8 years. The problems that this bill attacks have not disappeared during 8 years; they have worsened during that 8-year period. There may be additional new abuses that have come on the scene, additional new problems that have come on the scene. But that is not, I don't believe, a reason to ignore the fact that this bill targets real problems. It targets the homestead exemption abuses, it targets fraud and those sorts of things. So this bill responds to problems that are still endemic in the system.

Senator FEINGOLD. What about my question? Are there any changes to the bill that need to be made at all or is it exactly the way it should be? We are marking this thing up next week. The train is leaving the station, apparently, and there is probably not going to be another bankruptcy bill for a very long time. This is it. Should this bill be changed?

Mr. ZYWICKI. I believe that this bill is fine as it is.

Senator FEINGOLD. Not one word?

Mr. ZYWICKI. There is no word that I would change in this particular piece of legislation.

Senator FEINGOLD. Well, Mr. Chairman, I know my time is up, but the idea that after 8 years and all the economic changes in this country that there wouldn't—

Chairman SPECTER. If you need some more time, Senator Feingold, go ahead.

Senator FEINGOLD. Let me just say that after 8 years, the notion that there wouldn't be anything different about the Bankruptcy Code—with all the economic changes and dislocations, that there wouldn't be a word to change is not credible to me and is a further reason why I am very concerned about the speed with which this bill is moving.

Thank you for the extra time, Mr. Chairman.

Chairman SPECTER. Thank you, Senator Feingold.

The timing on the bill has been set. We are moving ahead. This hearing was designed to give us opinions of experts in the field on problems in the bill. We will have many communiques from interested citizens in all walks of life, and when the Judiciary Committee meets next Thursday to consider the bill, there will be time between that session and the full floor debate. So there is time for consideration of any changes that ought to be made.

We thank you all for coming, ladies and gentlemen. We very much appreciate it. Many of you have come from long distances and it has been a very productive hearing. That concludes our hearing, and thank you.

[Whereupon, at 12:34 p.m., the Committee was adjourned.]

[Questions and answers and submissions for the record follow.]

QUESTIONS AND ANSWERS

Questions from Chairman Arlen Specter
Bankruptcy Reform Hearing
February 10, 2005

Questions for Maria T. Vullo

1. You testified that the in defendants the Nuremberg Files case were able to relitigate the issue of whether they caused 'willful and malicious injury' in the various bankruptcy courts across the country. Why couldn't judgment debtors in future cases such as yours still litigate dischargeability if we passed legislation including the amendment you support?

2. I understand that you have obtained judgments in FACE Act cases totaling over $100 million. It appears as though you have been able to successfully litigate the issue of whether these judgments are dischargeable in bankruptcy in your clients favor. Nonetheless, in your testimony you urge that "[a]n amendment is necessary to prevent further abuse of our court system." In light of that, what benefit would there be to your clients and future prevailing plaintiffs under the FACE Act if we were to adopt Senator Schumer's proposed language?

3. In your testimony you cite *Planned Parenthood of Columbia/Willamette, Inc. v. American Coalition of Life Activists*, 41 F.Supp.2d 1130 (D.Or. Mar 16, 1999), a case that was affirmed in part (injunctive relief) and vacated in part (punitive damages) upon *en banc* review by the Ninth Circuit. *See Planned Parenthood of Columbia/Willamette, Inc. v. American Coalition of Life Activists*, 290 F.3d 1058, 2 Cal. Daily Op. Serv. 4198, 2002 Daily Journal D.A.R. 5559 (9th Cir.(Or.) May 16, 2002) (NO. 99-35320, 99-35331, 99-35325, 99-35333, 99-35327, 99-35405), rehearing en banc denied (Jul 10, 2002), as amended (Jul 10, 2002), *cert den'd*, 539 U.S. 958 (2003). I understand that upon remand, the District Court upheld the punitive damages awards to the plaintiffs against all defendants jointly and severally. *See Planned Parenthood of Columbia/Willamette, Inc. v. American Coalition of Life Activists*, 300 F.Supp.2d 1055 (D.Or. Jan 28, 2004). Nonetheless, the Court observed that "despite tremendous post-judgment collection efforts, plaintiffs' recovery to date has been *de minimus.*" *See Planned Parenthood of Columbia/Willamette, Inc. v. American Coalition of Life Activists*, 300 F.Supp.2d 1055, 1065 n. 9 (D.Or. Jan 28, 2004). In light of all the foregoing, what is the status of your collection efforts?

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February 24, 2005

Via Facsimile

Senator Arlen Specter
Chairman
United States Senate
Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, DC 20510-6275

Attn: Barr Huefner

S.256 & Proposed Clinic Violence Amendment

Dear Chairman Specter:

I write in response to the three questions attached to your February 17, 2005 letter regarding my hearing testimony on February 10, 2005. I respond below to the three questions in the order in which they are set forth in your letter:

1. You have asked whether future judgment debtors could litigate dischargeability were the proposed amendment to be passed. Without addressing specific language of any proposed legislation, I believe that future judgment debtors may always *seek* to litigate dischargeability, but the proposed amendment would make it very difficult for them to do so and would close the present loophole in the Bankruptcy Code that allowed six defendants in *Planned Parenthood of the Columbia/Willamette et. al* v. *American Coalition of Life Activists et al* ("ACLA case") improperly to invoke the

automatic stay provision of chapter 7 and delay judgment collection for over three years as a result. There can be no question that the ACLA case was fully litigated, and thus for the defendants to have filed for chapter 7 protection after they lost at trial was an abuse of the Bankruptcy Code. The defendants were represented by multiple counsel who fiercely litigated the case from its inception and all the way to the U.S. Supreme Court. Yet, after losing at trial, six of the ACLA defendants sought to eviscerate the years of litigation by filing for chapter 7 protection on the eve of their scheduled post-judgment depositions, in an obvious improper attempt to evade and/or delay judgment collection and the assets discovery proceedings which were underway. The district court and appeals court had denied defendants' motions for a stay pending appeal, and defendants failed to post a bond as required by the Federal Rules. Defendants had also stated publicly that they had no intention of paying any part of the judgment; thus, in contrast to the debtors that the Bankruptcy Code is intended to protect, the ACLA defendants did not seek chapter 7 protection to work out a payment plan with creditors but rather to avoid paying anything at all after losing at trial.

During the more than three years that the six chapter 7 cases were pending, the defendants/debtors obtained the benefit of the automatic stay provision, which precluded my clients from obtaining any discovery or collecting on their judgment without proceeding in six different venues across the country. In each of those six bankruptcy courts, we litigated the "willful and malicious injury" provision of the current Bankruptcy Code, which required the filing of extensive motions setting forth why the findings of the jury and judge were the equivalent of "willful and malicious injury" as that phrase is interpreted under bankruptcy court cases in the various circuit and district courts across the country. This relitigation was necessary under the current Bankruptcy Code even though the jury and trial judge in the ACLA case had found that the defendants intentionally threatened the plaintiffs with bodily harm. The time and expense incurred in such relitigation was enormous, nearing almost $1 million in fees and expenses for the bankruptcy proceedings alone.

An amendment to the U.S. Bankruptcy Code that makes it clear that judgments rendered under the FACE statute (or similar statutes) are nondischargeable in bankruptcy would eliminate the type of relitigation and wasted time and expense that the ACLA case generated, because, in contrast to the general "willful and malicious injury" exception, there would be a specific provision relating to dischargeability that addresses judgment debts arising out of clinic violence or threats of violence. In other words, were a future FACE defendant to file for chapter 7 protection (and it would be questionable whether such a filing could be in good faith), the proposed amendment would merely require the future prevailing plaintiff(s) simply to make a straightforward motion setting forth that the judgment was rendered under FACE, without more required.

2. The second question asks what benefits would inure to my clients and future prevailing plaintiffs under the FACE statute were Senator Schumer's proposed amendment to be adopted. I have answered this question in part in my response to

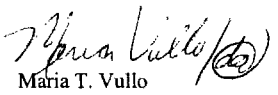
question 1 above. Were an amendment adopted that states clearly that FACE judgments are nondischargeable, my clients and other prevailing plaintiffs would not have to incur the enormous expense that we incurred to litigate the "willful and malicious injury" provision and related issues in multiple bankruptcy courts. Although I was ultimately successful in all six bankruptcy courts, were the proposed amendment to be adopted, future abuse of the bankruptcy laws would be greatly reduced, because it indisputably would be frivolous conduct (likely subject to sanctions) for a bankruptcy attorney to file a chapter 7 petition, or file papers seeking to discharge the FACE debt, under the Bankruptcy Code as I propose be amended. And, as stated above, were a defendant to file for chapter 7 protection, the dischargeability question would be very simple, requiring a short motion simply setting forth that the debt arose under FACE. By contrast, in the ACLA case, the delay that we experienced in being able to proceed with judgment collection allowed defendants, among other things, to move residences and otherwise make their assets unavailable to creditors. Statute of limitations issues might also arise due to the delays inherent in the current Bankruptcy Code. Moreover, although my firm handled the matter *pro bono,* there is no guarantee that future prevailing plaintiffs will have the assistance of *pro bono* counsel who could appear, without cost to the clients, in multiple bankruptcy courts across the country.

In short, there is no legitimate reason for judgment debtors to forestall judgment collection and discovery regarding their assets by triggering the automatic stay provision of the U.S. Bankruptcy Code, when there is no basis for seeking a discharge of a particular debt. A clear statutory provision stating that FACE judgments are nondischargeable would go a long way to preventing such abuse. It is important to stress that the defendants in these cases do not believe they are required to abide by the laws of this country – indeed, the defendants in the ACLA case so testified – and thus they are not the honest but unfortunate debtors that the U.S. Bankruptcy Code, and its automatic stay provision, is intended to benefit.

3. Finally, you have asked for the status of our judgment collection efforts. We continue to pursue judgment collection. The last of the six bankruptcy cases has only recently been concluded. We recently learned that one of the judgment debtors who had filed for bankruptcy and obtained the benefit of the automatic stay provision, Michael Bray, sold his house in Maryland (where he had filed for chapter 7 protection) and moved to Ohio in contravention of his legal obligations. We have commenced proceedings with respect to that matter. We also have proceeded to register the judgment in various district courts around the country, which is a requirement when defendants move to a different county or district. And, we continue to seek information with regard to any assets of any of the defendants, wherever they may be found. In order to protect my clients' interests and prevent defendants from further placing their assets out of reach of creditors, we are not able to provide further details of our judgment collection efforts.

I hope that the above assists the Committee in its deliberations on this important issue. Please let me know if I can be of any further assistance.

Respectfully,



Maria T. Vullo

MTV:de

Senate Judiciary Committee
Bankruptcy Reform Hearing
February 10, 2005

Senator Jeff Sessions
Written Follow Up Questions for Mr. Zywicki

1) Professor Warren cites a number of corporate bankruptcy cases that she links to scandal and fraud.

a. Do you believe that Congress should address corporate scandal and fraud cases through securities law or bankruptcy law?

Those cases generally appear to be best addressed through securities law. Bankruptcy law is most effective at determining whether a company should be reorganized as a going-concern entity, regardless of the factors that brought them into bankruptcy in the first place.

b. Do corporate scandals have anything to do with consumer bankruptcy law?

No.

c. Should the effects of these cases be addressed through a legislative fix to S. 256?

The fact that new and additional concerns arose during the many years during which BAPCPA was pending does not alleviate the need for bankruptcy reform. It may make a case for additional review of the bankruptcy system but it certainly does not detract from the need for bankruptcy reform.

2) Professor Warren's testimony referred to a number of abuses of the homestead exemption and indicates that the bill does not do anything about them.

a. Does the bill contain provisions to deal with the abuses cited by the Professor? If so, please list those provisions and explain the protections those provisions provide.

Yes, there are several new provisions:

- *§522(a)(3) extends the waiting period before a debtor can avail himself of a new state's exemptions, including homestead exemptions*
- *§522(o) permits a 10-year look-back period for the use of a homestead exemption with the intent to hinder, delay, or defraud a creditor*
- *§522(p)(1) limits the allowed value of a homestead exemption acquired during the 1215-day period preceding bankruptcy*
- *§522(q) caps the value of homestead exemptions for crimes or violations of securities laws*

b. If we had passed the bill eight years ago would the abuses that Professor Warren cites in her testimony have still occurred?

No, many of the abuses about which she is concerned are specifically addressed by BAPCPA.

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3) Professor Warren asserts that under the bill all debtors are treated the same regardless of income.

a. Is that true? How are debtors with different income levels treated?

That is not true. The means-test applies only to those who earn above the state median income; those below are unaffected.

b. Does the bill contain a safe harbor provision? Why or why not?

I'm not sure I fully understand the "safe harbor" referred to here. The bill retains the preexisting "totality of circumstances" test for determining abuse, primarily to address the problem of debtors strategically arranging their affairs to avoid the means-test. Otherwise, this provision will apply as it previously has.

4) S. 256 changes the priority for women and children trying to collect alimony and child support from a 7th priority to a 1st priority status.

a. Is this a significant change in the status quo?

Yes. Child support collection experts have testified on numerous occasions that this is significant.

b. How will this change affect women and children seeking to collect such payments from?

It will make it much easier.

c. Will women and children trying to collect alimony or child support have to compete post discharge with credit card companies?

No, absolutely not. Those collecting domestic support obligations have many, many rights and powers that ordinary creditors lack. Experts have stated that there simply is no competition among these creditors. Experts further testify that the largest obstacle to collecting domestic support obligations had been the bankruptcy code and that BAPCPA addresses those problems.

5) You told Senator Feingold that you did not believe there were any changes that needed to be made to the language of S. 256. Would you please explain / clarify your statement to that regard?

Thank you for giving me the opportunity to clarify this statement. This question was posed at the end of a very long hearing during which the focus was on whether BAPCPA had become obsolete during the 8 years that it had been pending. My view was that although new problems had arisen in the meantime, those issues were unrelated to the issues covered in the bill and that the issues covered by the bill had certainly not improved on their own during the 8 year period. Thus, the purpose of my statement—in that context—was to make the point that nothing during the preceding 8 year period had reduced the need for the legislation under consideration.

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Senator Tom Coburn's Questions:
Submitted to Professor Todd J. Zywicki

1) Professor Warren has raised the issue of whether bankruptcy petitioners who have medical debt are treated unfairly under the means test. Can you comment?

I can ascertain no reasonable basis for Professor Warren's opinion. The formula for calculating the means-test (11 U.S.C. §707(b)(2)(A)(ii)(I)) specifically subtracts "reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor."

a. Where the means test refers to "other necessary expenses," doesn't that include the debtor's actual medical expenses?

Yes.

b. Isn't there express language in the bill that provides for reasonable and necessary actual expenses related to elderly, chronically ill or disabled family members, whether they live with the debtor or not?

Yes. See *11 U.S.C. §707(b)(2)(A)(ii)(II).*

2) Wouldn't any medical expenses not covered by the "other necessary expenses" language be covered under the special circumstances test?

Yes.

3) I understand that rates of bankruptcy vary widely all over the country. One example I have read about is Memphis, Tennessee, which since at least 1989 has had the highest filing rate in the country – approximately 10 times the national average, even though it has a low unemployment rate and generally healthy economy.

a. Do you think that people who live in Memphis have ten times the number of health problems as the rest of the nation?

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No. I've seen no evidence to support such a claim nor is it even plausible.

b. Do you think that they get 10 times the amount of credit?

Not that I'm aware of.

c. Is bankruptcy generally caused by just one factor?

No. Moreover, debtors who face financial setbacks do not invariably respond by filing bankruptcy—other factors enter the decision as to whether to file bankruptcy once one suffers a financial setback.

4) This bill is neutral as to the cause of a debtor's bankruptcy – do you find that problematic?

No. The bill focuses on whether an individual has the ability to repay some of his debt as a condition for filing bankruptcy.

5) Isn't it true that medical professionals provide valuable services to their communities? Do you believe that medical professionals should be any less entitled to recover a portion of their expenses than other creditors, if a bankruptcy petitioner is capable of paying some or all of his or her debts?

No. It is sad and unfortunate when an individual is forced into bankruptcy by medical problems and medical debts, and it is proper (in my opinion) to allow a debtor a discharge from crippling debts. Yet when one person fails to pay his debts, those losses get passed on somewhere else in the system, either in lower-quality care, more expensive health care, or lower incomes for health care professionals. It is difficult for me to understand why a nurse or doctor who delivers a baby or provides life-saving medical treatment should have less of a right to be paid for their good services than other creditors or the IRS. Thus, it seems appropriate to require bankruptcy filers who can do so to pay what they can to these creditors.

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SUBMISSIONS FOR THE RECORD

ATTORNEY GENERAL OF TEXAS
GREG ABBOTT

February 2, 2005

The Honorable John Cornyn
United States Senate
517 Hart Senate Office Building
Washington, DC 20510

RE: Fairness in Bankruptcy Litigation Act of 2005

Dear Senator Cornyn:

I support your important initiative to prohibit opportunistic forum shopping by corporate debtors.

As you know firsthand from your tenure as Attorney General of Texas during the State's involvement in the Enron bankruptcy proceedings, such unsavory court-shopping truly harms innumerable parties - large and small alike. Far too often, corporate debtors file for bankruptcy in a far-flung district solely because of their incorporation in the state where that district is located.

Your proposal to amend 28 U.S.C. § 1408 - the aptly named Fairness in Bankruptcy Litigation Act - would prevent this unseemly practice. As you know, bankruptcy forum shopping can adversely impact not just states and state agencies, but countless consumers, creditors, employees, pensioners, stockholders, and small businesses that are regularly thwarted from protecting their interests simply because the debtor filed in a distant forum.

The venue stratagems used by large law firms to maximize their professional fees, render far-away courts inaccessible to scores of unsecured creditors, and select compliant, debtor-friendly judges undermine the credibility of our nation's bankruptcy system. Indeed, after two years of public hearings, the National Bankruptcy Review Commission recommended that Congress overhaul the law to prevent forum shopping by large Chapter 11 debtors and their affiliates. I strongly support their recommendation and applaud you for bringing this urgent matter to the attention of the United State Senate.

Abusive forum shopping by corporate debtors harms Americans from all walks of life. It is time for this gamesmanship to stop. I commend your efforts to strengthen our bankruptcy system and safeguard the interests of ordinary Americans.

Sincerely,

Greg Abbott
Attorney General of Texas

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February 8, 2005

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Re: Committee Hearing on S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," Scheduled for February 10, 2005

Dear Mr. Chairman:

As you and your colleagues begin your consideration of S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," the American Bar Association (ABA) respectfully urges you to oppose several provisions in the legislation that would unfairly increase the liability and administrative burdens of bankruptcy attorneys under the Bankruptcy Code. In particular, the ABA urges you to oppose those provisions in the bill that would require attorneys to: (1) certify the accuracy of factual allegations in the debtor's bankruptcy petition and schedules, under penalty of harsh court sanctions; (2) certify the ability of the debtor to make payments under a reaffirmation agreement; and (3) identify and advertise themselves as "debt relief agencies" subject to a host of new intrusive regulations. Attached for your review and consideration are specific amendments proposed by the ABA that would eliminate these provisions and replace them with alternative language that would be more effective in reducing bankruptcy fraud and abuse. It is our understanding that these and other bankruptcy issues will be discussed during your committee's hearing on February 10, 2005, and we ask that this letter be included in the hearing record.

The ABA, with over 400,000 members throughout the country, strongly opposes the attorney liability provisions contained in S. 256 that apply only to debtors' counsel. In our view, these provisions will have a strong negative impact on individual debtors who are seeking a fresh start under the bankruptcy laws by subjecting their attorneys to costly new regulations and liability beyond those faced by lawyers in any other field of practice. These three provisions, discussed in greater detail below, would discourage many attorneys from agreeing to represent debtors at all, while greatly increasing the fees and expenses of clients who are able to obtain legal representation. In addition, these provisions will discourage many, if not most, lawyers from volunteering their services for *pro bono* bankruptcy cases. Unless they are removed, these provisions pose a serious threat to the efficient operation of the bankruptcy system.

February 8, 2005
Page 2

Certification of Bankruptcy Petitions and Schedules

The ABA strongly opposes the provisions in S. 256 that would require the debtor's attorney to certify the accuracy of all factual allegations in the debtor's bankruptcy petitions and schedules and would subject the attorney to harsh court sanctions if any factual inaccuracies resulted in the dismissal of the debtor's Chapter 7 bankruptcy petition or in its conversion to a Chapter 13. During House-Senate conference committee negotiations in 2002 on the predecessor to S. 256, H.R. 333, the provision requiring the court to impose sanctions against attorneys for inaccurate bankruptcy schedules was replaced with a discretionary standard. Although that change was a significant improvement, the current language contained in S. 256 will still have severe negative effects on the bankruptcy court system.

Under current Bankruptcy Rule 9011, bankruptcy attorneys, like all other attorneys appearing in federal courts, are required to certify that pleadings and other items that they prepare are supported by the facts before they are filed with the court. This rule, which is identical in form and substance to Federal Rule of Civil Procedure 11, applies to all pleadings and motions filed with the bankruptcy court. By its own terms, however, Rule 9011 does not apply to the bankruptcy schedules listing the debtor's financial information. Because those schedules are prepared almost entirely with information supplied directly by the debtor, Rule 9011 allows bankruptcy attorneys to rely upon the accuracy of that information. Therefore, the debtor alone has been held responsible for the truthfulness and accuracy of the bankruptcy schedules.

Section 102 of S. 256 would change existing law by creating a new and higher standard for debtor bankruptcy attorneys that goes well beyond the standards imposed upon other attorneys. By creating new subsections 4(A) – (D) to 11 U.S.C. § 707(b), Section 102 of the bill would hold the debtor's attorney—instead of the debtor—financially responsible for any factual errors contained in the debtor's bankruptcy petition or schedules. Therefore, if even innocent errors in the petition or the schedules result in the dismissal of the petition or in its conversion to a Chapter 13 proceeding, the debtor's attorney could be held financially responsible unless it is proven that the attorney conducted a time-consuming and costly investigation of these factual allegations before the filing.

In addition, while current Rule 9011 holds all bankruptcy attorneys to the same standards, Section 102 of S. 256 unfairly discriminates between debtor and creditor attorneys. Section 102 provides that if the debtor's petition or schedules are found to violate Rule 9011 and the debtor is denied a discharge under the means test outlined in S. 256, the debtor's attorney would be subject to court sanctions and could be held personally liable for the attorneys' fees of the trustee or bankruptcy administrator who contested the discharge. In contrast, attorneys representing creditors would not be required to make any additional certifications and would not be made subject to new sanctions under the legislation.

The new standards outlined in Section 102 of the bill also would fundamentally alter the attorney-client relationship in bankruptcy cases. It would transform the attorney from an advocate to a detective and informer. The legislation would create an unwaivable conflict of interest because the attorney would be unable to accept information provided by the client at face

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value without risking liability if the information later proved to be inaccurate. Further, the debtor's attorney would be required to independently verify all of the client's factual representations. Indeed, the attorney would be forced to appraise the value of all of the assets listed on the client's schedules.

Requiring the debtor's attorney to verify all of the client's representations would significantly raise the cost to the debtor of filing for bankruptcy. As a result of the new obligations and liability imposed on attorneys by Section 102, many bankruptcy lawyers will no longer agree to accept debtors' cases because they will not be willing to become their client's insurer. In addition, those bankruptcy lawyers who continue to represent debtors will be forced to charge substantially higher fees (which most debtors will be unable to afford). Therefore, the practical effect of these provisions will be to deny debtors timely, effective, and affordable representation just when they need it most.

In addition, even when a debtor is fortunate enough to find an attorney who is willing to handle the bankruptcy case, the new potential liability created by Section 102 will have a severe chilling effect on the attorney's willingness to advocate a new position or theory on behalf of the client. Because the debtor's attorney could face substantial monetary sanctions if the attorney's efforts to maintain a Chapter 7 case are unsuccessful and the court finds that Rule 9011 was violated, the debtor's attorney will be reluctant to advance any but the most well-established legal theories and arguments. As a result, debtors will no longer receive the kind of vigorous representation to which they are entitled under the law and which attorneys have always been required to provide. For all of these reasons, the ABA believes that new subsections 4(A) – (D) contained in Section 102 are counterproductive and should be removed from the bill.

Certification of Reaffirmation Agreements

The ABA also opposes those provisions in Section 203(a) of the bill that would require attorneys to certify the debtor's ability to make payments under a reaffirmation agreement.

Under current law, a debtor is not required to accept the discharge of all outstanding debt. Instead, the debtor may choose to reaffirm certain debts—thus retaining liability for these debts—provided that the decision is voluntary and will not create undue hardship for the debtor. Before such reaffirmation agreements can proceed under current law, however, the debtor's attorney must certify that the reaffirmation is voluntary and will not impose an undue hardship on the debtor or the debtor's dependents.

Section 203(a) would change these procedures by again imposing new burdens on the debtor's attorney. Unlike the current law, which simply requires the debtor's attorney to certify in writing that the reaffirmation agreement is voluntary and would not cause the debtor undue hardship, the new provisions require the attorney to certify that "the debtor is able to make the [reaffirmation] payment," in cases where there is a presumption of undue hardship under the debtor's budget (i.e., if the debtor's monthly income is less than monthly expenses, including the reaffirmation payments).

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Bankruptcy attorneys are not accountants and are neither trained nor equipped to conduct extensive audits of their clients' finances, nor do they make financial or household budgeting decisions for their clients. Indeed, this is not the attorney's proper role, and any attempt to force the attorney to assume these duties will substantially increase the cost of representing a debtor in bankruptcy. Therefore, this certification requirement, like the certification requirement in Section 102, will discourage many attorneys from representing debtors, while forcing the remaining debtors' attorneys to charge higher fees to cover the substantial additional costs and risk.

The new certification requirement contained in Section 203(a) also will create strong conflicts of interest between the debtor and the attorney in those instances when the debtor wants to reaffirm a debt and instructs the attorney to certify the debtor's ability to make payments. If the attorney follows the client's directive, the attorney may become subject to sanctions under Rule 9011 if the debtor later proves unable to pay the reaffirmed debt. This new mandate is particularly unfair because creditor's attorneys are not subject to sanctions under Rule 9011 for their clients' false disclosures or illegal collection practices even if they acted in bad faith for vexatious purposes. For all of these reasons, the ABA believes that the provisions in Section 203(a) requiring debtors' attorneys to certify their clients' ability to make reaffirmation payments are inappropriate and should be deleted from the bill.

"Debt Relief Agency" Provisions

The ABA also strongly opposes those provisions in Sections 227-229 of the bill that would require bankruptcy attorneys to identify and advertise themselves as "debt relief agencies" and then comply with a host of new burdensome regulations. These provisions would confuse the public, seriously interfere with the attorney-client relationship, and impose unfair additional burdens and liability on debtors' attorneys that constitute an unjustified government invasion of the relationship between private attorneys and their clients.

Under these provisions, any "person"—including both bankruptcy attorneys and non-attorney "bankruptcy petition preparers"—who assists individual debtors with their bankruptcies in return for compensation is deemed to be a "debt relief agency." Unfortunately, the provisions fail to take into account any of the important differences between attorneys and non-attorneys providing bankruptcy services. Under current law, only attorneys are permitted to give legal advice, file pleadings, or represent debtors in bankruptcy hearings. In addition, unlike non-attorney bankruptcy petition preparers, only attorneys are licensed by the state in which they practice, bound by canons of ethics, and subject to discipline by the courts in which they practice. More importantly, only those communications between the debtor and his or her attorney are protected by the attorney-client privilege. Requiring both attorneys and non-attorney bankruptcy petition preparers to advertise themselves as "debt relief agencies" would obscure these important distinctions while creating substantial confusion among the public.

The "debt relief agency" provisions in the bill would also interfere with the attorney-client relationship in a variety of ways. Because the definition is worded so broadly, it may be construed to apply not just to bankruptcy attorneys, but also to family attorneys, criminal and

civil defense attorneys, and general practitioners who, in the course of representing their clients, are compelled to advise them to consider filing bankruptcy to protect their rights. This will jeopardize the attorney's ability to properly advise his or her client regarding their legal rights.

Any attorney who assists a client with bankruptcy will be subject to a long list of new regulations under the bill. In particular, attorneys will be required to provide lengthy written disclosure statements to potential and existing bankruptcy clients that explain the bankruptcy system and that provide general, government-approved legal advice. In addition, attorneys will also be required to advise the debtor in writing that the debtor need not be represented by a lawyer in the bankruptcy or in related litigation, which in many cases is bad advice.

By requiring that the debtor's attorney provide the debtor with preprinted, government-approved legal advice on bankruptcy law, and by forcing the attorney to state in writing that the debtor need not even retain a lawyer, the bill would usurp the attorney's role as the proper legal representative of the debtor. Perhaps even more troubling, the bill would also prohibit the attorney from giving certain proper pre-bankruptcy planning advice to the client, including advice to pay certain lawful obligations or to incur certain debts. In fact, these provisions of the bill are worded so broadly that the attorney could be subject to liability merely for making an unsuccessful attempt to help the client restructure the debt to avoid bankruptcy. These provisions, which dictate the types and content of legal advice that an attorney can and cannot render to his client, are particularly destructive of the attorney-client relationship.

Sections 227-229 also require attorneys to provide the debtor with a written contract, and if the contract fails to comply with each of the detailed requirements outlined in the bill, it would be void and unenforceable. Furthermore, if the debtor's attorney failed to follow any of the many technical requirements of the legislation, the attorney would forfeit the entire fee and could be sued in state or federal court by the debtor, the trustee, or state law enforcement officials for actual damages, civil penalties, attorneys' fees, and costs. Although existing law and ethical rules require all attorneys to provide quality legal representation to their clients, Sections 227-229 go well beyond existing law and would subject just one type of attorney—debtors' bankruptcy attorneys—to a far stricter standard than attorneys in any other field of practice.

In addition, Section 229 also seeks to micromanage the bankruptcy attorney's advertising by requiring the attorney to include a conspicuous—and awkward—statement in all its advertising stating that "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code." No such requirements will apply to creditors' attorneys under the bill. In addition, requiring attorneys to label themselves as "debt relief agencies" will discourage general practitioners and bankruptcy professionals who have a consumer and business, debtor and creditor practice, from advertising the availability of bankruptcy services, thus limiting consumer bankruptcy representation to attorneys with narrower practices. For all of these reasons, the ABA believes that attorneys should be exempted from the coverage of the "debt relief agency" provisions contained in Sections 227-229.

The three general types of enhanced attorney liability provisions outlined above, when taken together, will have a substantial negative impact on the availability of quality legal counsel in

bankruptcy. As a result of these burdensome and one-sided mandates on debtors' attorneys, many attorneys who currently represent both debtors and creditors will stop handling debtor cases altogether rather than comply with these new regulations. With fewer attorneys available to represent debtors, many more debtors will be forced to file their bankruptcies *pro se*, without first obtaining adequate advice regarding the necessity or advisability of filing for bankruptcy. Therefore, the enhanced attorney liability provisions ultimately will have an adverse effect on debtors, creditors, and the bankruptcy system as a whole.

To avoid these problems, the ABA has crafted proposed amendments that would replace the current attorney liability provisions in S. 256 with tough new *non-dischargeable* sanctions against debtors who lie on their bankruptcy schedules and new language urging the bankruptcy courts to vigorously enforce existing Rule 9011 of the Federal Bankruptcy Rules when misconduct by any party is shown. These reforms will reduce bankruptcy fraud and abuse without unfairly harming honest debtors or the overall bankruptcy system, and we urge you to add these amendments to S. 256. A copy of the ABA's proposed amendments is enclosed for your consideration.

Thank you for considering the views of the ABA on these important matters. If you would like more information regarding the ABA's positions on these issues, your staff may contact our legislative counsel for bankruptcy law issues, Larson Frisby, at (202) 662-1098.

Sincerely,

Robert D. Evans

Encl.

cc: All members of the Senate Judiciary Committee

February 15, 2005

The Honorable Arlen Specter
Chairman
U.S. Senate Committee on the Judiciary
224 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Specter:

The American Land Title Association* supports the provisions in the Senate Bankruptcy Reform Act to clarify In re McConville. Amendments clarifying McConville have been included in Bankruptcy Technical Corrections legislation since 1997. They are also in the Senate version of S. 256, this year's "Bankruptcy Abuse Prevention and Consumer Protection Act." We ask that this letter be included in the Committee's hearing record of February 10, 2005.

State and local real property recording acts provide all parties with a single, comprehensive method to search title and ascertain the existence of interests in real property. Bankruptcy Code section 549(c) was specifically intended to preserve the integrity of the state recording acts by protecting buyers, lenders, lessees, and other parties who, in return for their interest in real property, advance new value in good faith without knowledge of a bankruptcy filing. Using the state recording system, constructive knowledge of a bankruptcy filing is provided to all parties by recordation of a copy of the bankruptcy petition by the bankruptcy estate in the counties where the bankruptcy estate owns real property.

This practical system of deference to the state real property recording acts as envisioned by section 549(c) was undermined by the decision of the Ninth Circuit in In re McConville, 110 F. 3d 47_(9th Cir.1996) cert denied 118 S.Ct. 412,139 L.Ed 2d 315(1997) 77 W.L. 136529 (9th Cir. 1997) (decided March 26, 1997 and withdrawing prior decisions reported at 84 F.3d 340 (9th Cir. 1996) and at 97 F.3d 316 (9th Cir. 1996)). In McConville, a purchase-money lender, without knowledge that the debtor had recently filed an undisclosed chapter 11 case, funded the debtor's acquisition of an apartment complex, and simultaneously recorded its purchase-money deed of trust. On these facts, the Ninth Circuit failed to apply section 549(c), instead limiting the application of section 549(c) to transfers of fee interests only and holding that a bona fide encumbrancer for value was not within the protection afforded by section 549(c). In its last decision, the court, attempting equity, applied Sec. 364 of the Code, and found it breached. The court remanded with direction to modify to give the lenders a limited lien, which the trustee paid.

Limiting section 549(c) to transfers of fee interests only, puts at risk every real property lessee, easement grantee, and lender who provides consideration or extends credit in return for its interest in real property in reliance upon the state real property recording acts. Because it is a practicable impossibility for the title insurance industry to search contemporaneously bankruptcy

*The American Land Title Association membership is composed of 2,400 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. These firms and individuals employ nearly 100,000 individuals and operate in every county in the country.

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filings in bankruptcy court in all 50 states at the time of closing, were the decision in McConville allowed to stand, the existence of an undisclosed bankruptcy case places the risk of loss on the lending, leasing and development industries, potentially chilling credit availability.

McConville is solved by simple amendments to clarify the law enacted in 1978. First, with respect to the Automatic Stay, section 362(b) of the Bankruptcy Code should be amended to clarify that postpetition transfers required to be perfected under section 549(c) and which are otherwise immune from attack under section 549 would not be void or violable as made in violation of the automatic stay. (Sec 311 of S. 256) Second, with respect to postpetition transactions, section 549(c) should be clarified to apply to "transfers of interests in real property, including a security interest in real property" where the purchaser has given fair equivalent value without notice of the pendency of the bankruptcy case and has perfected that interest timely. (Sec. 1201.) To clarify that section 549(c) of the Bankruptcy Code applies to encumbrancers, the definition of "transfer" in section 101(54) should be amended by inserting "the creation of a lien." (Sec. 1204)

We thank the sponsors for including these provisions in S. 256 and look forward to working with the Committee on this important legislation. For additional information, please contact Ann vom Eigen, ALTA Legislative and Regulatory Counsel, at 202-296-3671, ext. 214, or ann_vomeigen@alta.org.

Sincerely,

Ann vom Eigen
Legislative and Regulatory Counsel

Cc: The Honorable Patrick Leahy
Ranking Member
Committee on Judiciary
United States Senate
Washington, DC 20510

42675.018

CUNA & Affiliates

Credit Union National Association, Inc.
805 15th Street, NW Suite 300
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(202) 682-4200

WRITTEN TESTIMONY OF

KENNETH H. BEINE

PRESIDENT, SHORELINE CREDIT UNION

ON BEHALF OF

CREDIT UNION NATIONAL ASSOCIATION (CUNA)

BEFORE THE

SENATE JUDICIARY COMMITTEE

ON

S. 256, THE BANKRUPTCY ABUSE PREVENTION

AND CONSUMER PROTECTION ACT OF 2005

FEBRUARY 10, 2005

A member of the Credit Union System℠

WRITTEN TESTIMONY OF
KENNETH H. BEINE
PRESIDENT, SHORELINE CREDIT UNION
ON BEHALF OF
CREDIT UNION NATIONAL ASSOCIATION (CUNA)
BEFORE THE
SENATE JUDICIARY COMMITTEE
ON
S. 256, THE BANKRUPTCY ABUSE PREVENTION
AND CONSUMER PROTECTION ACT OF 2005
FEBRUARY 10, 2005

Good morning, Chairman Specter and other members of the Committee, particularly Senators Feingold and Kohl of my home state. I am Kenneth Beine, president of Shoreline Credit Union in Two Rivers, Wisconsin, and I appreciate the opportunity to be here to tell you about our concerns with bankruptcies and how they are impacting credit unions -- and my credit union in particular. I am speaking on behalf of the Credit Union National Association (CUNA), which represents about 90 percent of the 9,100 state and federal credit unions nationwide and their 86 million members.

We are very pleased that the Committee is holding today's hearing on S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. I sat in front of this committee nearly four years ago today with a message from America's Credit Unions. That message is the same today as it was then. Credit unions recognize that many people legitimately need the option to declare bankruptcy. What concerns us, however, are the cases of abuse by those who file Chapter 7 and totally walk away from their debt, even though they clearly have the ability to repay all or part of that debt.

Credit unions have consistently had three top priorities for bankruptcy reform legislation: a needs based formula, mandatory financial education, and maintaining the ability of credit union members to voluntarily reaffirm their debts. The bill before you today, while a product of compromise, does a good job of balancing these issues. We strongly urge the 109th Congress to pass this compromise bill as soon as possible. Any further dilutions may result in this bill not addressing the real bankruptcy problems facing America's consumers.

Shoreline is a $64.1 million state-chartered, federally insured credit union. We have a community-based charter, serving everyone who lives or works in Manitowoc County, and have over 11,300 members. Currently we have $43 million in loans to our members – some $12 million in car loans, more than $26 million in home-secured loans. In addition, we have issued about 1,800 credit cards for another $2 million.

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Nationwide non-business bankruptcy filings were nearly 1.21 million in the first nine months of 2004. While final full-year data is not yet available, the results from the first nine months suggest that full-year filings will exceed 1.61 million – nearly equaling the 1.62 million record level set in 2003. The 2004 total is likely to be about 1% lower than in 2003, but the slight slow-down isn't surprising given the improving economy. However, viewed in a broader historical context the results are disturbing: 1.21 million filings is one-third higher than the 2000 total, over double the national total recorded in 1994 and six times higher than the total in 1984.

Furthermore, the current near-record level of filings has occurred in a sharply improving economy. The U.S. economy grew 4.4% in 2004, its fastest increase since 1999. The U.S. unemployment rate averaged 5.2% in 2004, it's lowest showing since 2001. While we expect the economy to continue to grow at a healthy pace, we also expect bankruptcy filings to rise as higher market interest rates impose a heavier debt service burden on the nation's consumers. Household debt levels are at all-time highs and debt service burdens (the amount of take home pay consumers devote to paying debts) are near all-time highs.

Credit unions continue to be very concerned about these trends because their experiences with credit union members who file mirror the national experience. Data from credit union call reports to the National Credit Union Administration (NCUA) suggest that roughly 275,000 credit union member-borrowers will have filed in 2004 – a record number. This figure is 40% higher than the level of filings we witnessed in 2000. In addition, CUNA estimates that over 40% of all credit union losses in 2004 will be bankruptcy-related, and those losses will total approximately $900 million.

In Wisconsin we expect more than 28,000 total bankruptcy filings in 2004 a 2% increase over the 2003 total. The total number of credit union borrow-bankruptcies is on track to be 70% higher than those we experienced in 2000. This translates to a total of roughly 6,400 filings.

At Shoreline Credit Union, bankruptcy filings and losses have shown a steady increase since 1996. In 1996, losses due to bankruptcy as a percentage of total of all charged-off loans was 4.6 percent. That grew to 20 percent in 1997; 47.2 percent in 1998; 48.5 percent in 1999; 73.2 percent in 2000; 43.2 percent in 2001; 38.2 percent in 2002; 38.2 percent in 2003; 71.9 percent in 2003, and 50.3 percent in 2004. Of the 90 total bankruptcy filings during that period of time, all but 2 were Chapter 7.

As the number of member bankruptcies has increased, so too have the dollar losses to my credit union. Our loss from the one bankruptcy in 1996 was only $1,875, but in just one year the losses increased to $9,883 – an increase of over 500 percent. Since then, our losses have increased significantly: in 1998, losses were $15,309; in 1999, losses were $34, 577; in 2000, losses were $59,813; in 2001, losses were $77,177; in 2002, losses were $113,697; in 2003, losses were $115,191; and in 2004, losses due to bankruptcy dropped, but were still a robust $69,624. How much of these losses could have been prevented by a means test is unclear, but if we use the range often associated with

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abusive filings of anywhere from 3-15 percent, our modest credit union and its members could have saved anywhere from $15,000-$75,000 over this period of time.

Shoreline is a careful lender. We cannot afford to be otherwise. We do a good job with scrutinizing loan applications and carefully determining that the applicant is creditworthy before extending credit. We examine credit reports, verify income, and see that a reasonable debt-to-income ratio is maintained by the borrower. We even look at the applicant's disposable income to determine that the applicant can make the payments. We routinely monitor our credit cards and do not make across-the-board increases to the credit limit.

In an effort to combat the number of bankruptcies at the credit union, Shoreline has tightened its credit policies. We now use bankruptcy predictors as part of the credit granting process. We have increased collateral requirements and opt to require a co-signer or co-maker on more loans than in the past. We do not reissue cards to those members who are overextended or have a poor repayment history with the credit union. We have also introduced "risk-based lending" procedures.

If a member is experiencing financial problems and mentions bankruptcy to us, our loan officers inform the member of the downside to such an action – damaged credit, loss of services – and let the member know that the credit union is there to help them through the financial difficulty. We attend all 341 hearings, where creditors are permitted to question the debtor, and encourage reaffirmations by offering debtor-friendly terms.

Credit Unions Support Financial Education

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

Shoreline regularly refers members who are experiencing financial difficulties to the local CCCS and have found the program to be beneficial for the members and their families. We also try to educate our members about alternatives to bankruptcy. We address credit issues in our newsletter and sponsor annual Consumer Credit and Identity Theft seminars.

CUNA strongly supports the provision in S. 256 that requires a person contemplating bankruptcy to receive a briefing about available credit counseling and assistance in performing a budget analysis. We also strongly support the provision in this legislation that would prohibit the Chapter 7 or 13 debtor from receiving a discharge if the debtor does not complete a course in personal financial management. Any sensible bankruptcy reform should include education requirements to give debtors the tools they need to make wise decisions about filing for bankruptcy and to succeed financially after bankruptcy. In

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anticipation of this, CUNA plans to develop face-to-face and/or on-line courses to fulfill this aspect of the legislation.

We also strongly support amendments that would require a debt relief agency providing bankruptcy assistance to analyze the benefits of different forms of debt relief with the debtor and to emphasize the need for full and accurate disclosure of assets, liabilities and income.

Credit unions recognize that financial education needs to be available early on and before consumers experience financial problems. We are pleased that a financial management training test program is included as part of S. 256, as well as the provision encouraging states to develop personal finance curricula for elementary and high schools.

At Shoreline, we do our best to implement that philosophy. For example, we now operate a student credit union. It is a joint venture between Shoreline CU, River Wood-Maritime CU and the Two Rivers High School. It is operated by students from their business program over the lunch hour, on-line real time access, able to process deposits, withdrawals and check cashing transactions for both students & staff, with 4 of the 6 students employed (2 each) at our respective credit unions. In addition loan officers and operational staff are tapped as guest speakers to provide insights on lending procedures, the importance of good savings habits, etc.

Financial education is a high priority for our national trade association, too. Five years ago, CUNA and the National Endowment for Financial Education (NEFE) entered into a partnership whereby credit union volunteers teach financial education in our nation's schools. It is based on the philosophy that discipline in managing money is best achieved if it is learned early in life. Many credit unions had already been working with their local schools, as well as devoting office space for consumer libraries that enable members to use a wide range of financial periodicals, manuals, and books to learn more about money management.

Credit Unions have also differentiated themselves from other financial institutions in terms of giving college students credit cards. Many credit unions offer educational sessions on budgeting and using credit wisely on college and university campuses at various times during the year, including freshmen orientation and classes. Education is the key in helping college students to avoid falling into debt at an age where their main focus is on obtaining a college degree. By educating these students, credit unions help them to positively handle their personal finances and to make them even more attractive candidates for credit products such as auto loans and mortgages later in life. Many colleges and universities welcome credit union representatives to teach these courses on their respective campuses and continually ask these representatives to come back year after year.

In that regard, CUNA supports the provisions of the bill that require credit card companies to inform their customers of the financial risks of making only minimum

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payments, the prohibitions on deceptive advertising of low introductory rates, and the higher penalties for predatory debt collection practices.

I am confident that early financial education would have helped some young adult members of Shoreline Credit Union to make different decisions than they did. In one case, a couple in their mid-twenties decided that they wanted a "clean slate" prior to getting married. They ran up credit card purchases. One prepaid on an auto loan with us to have the cosigner released. (Both were employed full-time.) They both then filed for Chapter 7. My credit union's share of their version of financial planning was a write-off of almost $3,000 in credit card debt plus another couple of hundred dollars on the disposal of the auto.

In another case, an expectant young mother who lived at home with her parents (with a stable part-time job and a small automobile loan at Shoreline) wanted to quit her job, but didn't want to "burden her child with her credit problems," and asked if we would accept the car in full payment of the loan balance. My loan officer offered to rewrite the loan terms or suspend payments for several months and also informed her that she would still be responsible for the remaining balance on the loan after the sale of the car. She was not interested. She subsequently filed Chapter 7 and turned over the vehicle to us. We incurred about a $3,000 loss.

Even with financial counseling, I recognize there are instances in which bankruptcy may be the only alternative for some members, the way for them to get a much needed "fresh start." But I am not convinced that in either of these examples, bankruptcy was the right solution.

Credit Unions Support Reaffirmations as a Benefit Both to the Member and to the Credit Union

Because we are not-for-profit financial cooperatives, losses to the credit union have a direct impact on the entire membership due to a potential increase to loan rates or decrease in interest on savings accounts. Credit unions strongly believe that reaffirmations are a benefit both to the credit union, which does not suffer a loss, and to the member/debtor, who by reaffirming with the credit union continues to have access to financial services and to reasonably priced credit.

CUNA strongly supported the original House-passed bankruptcy bill in the 106th Congress, which did not materially amend the reaffirmation provisions. The bankruptcy bill that eventually passed and is preserved in S. 256, however, contained a lengthy disclosure statement for reaffirmations. The form is intended to assure that debtors entering into a reaffirmation agreement understand all aspects of signing that contract. CUNA appreciates the work of this committee, and the work of Senators Jeff Sessions (R-AL) and Jack Reed (D-RI), to recognize in the Section 203 language the unique relationships that credit unions have with their members.

Shoreline, like most credit unions, has a policy that if a member causes a loss to the credit union, services to that member, aside from maintaining a share account, will be withheld. Most credit union members take this seriously and continue to reaffirm on their credit union loans. However, we are beginning to see that some members do not care if they cause a loss and are denied service because they believe they can get credit elsewhere -- even though it may be at a higher rate. We continue to see more surprise bankruptcies, where the member is a long-time member and is current on his or her debt at the time the bankruptcy petition is received.

But not all stories are bad. Some members truly care about their fellow members and have a strong sense of responsibility when it comes to meeting their financial obligations. We recently had a member couple who had a number of bad decisions catch up with them. They were clearly living beyond their means. They started a business venture during a recession. They were unable to service their loans, so they sold their recreational vehicles (a large boat and a motor home). Their unsecured balance came to $25,000. Against advice from several quarters, they offered to cover the remaining balance with a second mortgage. We helped them with favorable (7%, 30yr) terms, and they are now on their way to restore fiscal control of their lives.

Perhaps the best way to understand the credit union movement's position that reaffirmation benefits **both** the member and the credit union is to provide another real life example. We had a middle aged couple file for Chapter 7 due to several medical problems and loss of employment. They reaffirmed their automobile loans with Shoreline. Although not required to repay their credit card loans, they were adamant about doing so, and did so quite voluntarily after discharge. Needless to say, today they are members in good standing, and need only ask to be granted future loans.

Credit Unions Support Needs-Based Bankruptcy

Credit unions are very anxious to see Congress enact meaningful bankruptcy reform and believe that "needs-based bankruptcy" presents the best opportunity to achieve this important public policy goal. Credit unions believe that consumers who have the ability to repay all or some part of their debts should be required to file a Chapter 13, rather than have all their debt erased in Chapter 7. Therefore, CUNA supports the needs-based provision that is contained in S. 256. This provision was a compromise developed out of the bankruptcy reform bills that received overwhelming support in the 106th Congress.

This section is the heart of the bill, taking direct aim at those that abuse the system. While I will provide examples of this abuse below, I want to call your attention to "official" recognition of this problem. The U.S. Trustee Program's Annual Report of 2002 indicates that the Program established a National Civil Enforcement Initiative and increased its criminal enforcement actions to address this problem. According to the report, "One of the U.S. Trustee Program's most critical responsibilities is to combat fraud and abuse in the bankruptcy system...This effort was undertaken to respond to mounting public concern that the bankruptcy system was being abused and that more

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should be done to protect the system by identifying and taking action against wrongdoers."

The report includes many examples of such abuse. But let me tell you about a case at my credit union that illustrates why needs-based bankruptcy and its provisions are needed. A young woman had an automobile loan from Shoreline Credit Union, with her mother as a co-signer. The daughter fell behind on the payments, and the mother offered to take over the loan completely if the credit union was willing to remove the daughter's name from the loan. Since the mother had a good credit and employment history, we agreed to do so. The woman filed for Chapter 7 *before* the due date of the first payment. We lost $6,000. We eventually learned that she had previously filed for bankruptcy and "didn't want her daughter to have the same credit problems."

And just two years ago we had a gentleman who hit us with a surprise bankruptcy, a few months after sitting in my office and promising to "never cause Shoreline a loss". He turned over several automobiles. We lost $11,000. He drove a newly leased vehicle to the discharge hearing. He has a documented gambling problem. The discharge included everything from multiple credit cards to payday loans to utility bills. His earnings? Between $40,000 and 60,000 per year. It turns out this was bankruptcy number 3. He has not changed his spending habits. He will be eligible to file again in 2008.

What this member did borders on fraud. People should not be able to use the bankruptcy code as a tool to avoid inconvenient obligations by transferring their debts to fellow consumers – my members – your constituents. This is wrong. This is abuse.

You have the power to make it right.

Again, let me say that I am pleased you are holding this hearing today. Credit unions are very anxious to see Congress enact meaningful bankruptcy abuse reform and believe that a needs-based bankruptcy system presents the best opportunity to achieve this important public policy goal. This hearing shows that the 109th Congress is continuing to move toward passage of bankruptcy abuse reform legislation, and we hope that bankruptcy reform will become law in the coming weeks.

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

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TESTIMONY OF

NATIONAL MULTI HOUSING COUNCIL/
NATIONAL APARTMENT ASSOCIATION

BEFORE

THE COMMITTEE ON THE JUDICIARY

U.S. SENATE

HEARING ON S. 256,

THE BANKRUPTCY ABUSE PREVENTION AND

CONSUMER PROTECTION ACT OF 2005

FEBRUARY 10, 2005

Chairman Specter, Ranking Member Leahy, and distinguished members of the Committee, I thank you for this opportunity to share the views of rental housing providers as you consider the issue of bankruptcy reform and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (S. 256).

My name is Malcolm Bennett and I am from Los Angeles, California where I am President and Founder of International Realty and Investments. I am proud to say that my company is one of the largest minority-owned property management and investment property firms in the city. In 1987, I also founded the Minority Apartment Owners Association which is a network rental property owners with rental property throughout Southern California. Today I am representing the National Multi Housing Council and the National Apartment Association (NMHC/NAA), whose combined memberships represent the nation's leading firms participating in the multifamily rental housing industry. Our memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is comprised of 164 affiliates and represents more than 31,505 professionals who own and manage more than 5 million apartments. NMHC and NAA jointly operate a federal legislative program and provide a unified voice for the private apartment industry.

As the chief representatives of the nation's rental housing providers, NMHC/NAA are uniquely qualified to speak about how the current bankruptcy law impacts our industry and the compelling need for reform. I would like to share with you some of the experiences of the apartment community in this area and how they have been negatively impacted by the abuses in the current system.

The Automatic Stay Provision

We agree that reform of the Bankruptcy Code should be comprehensive and meaningful. Today, I will limit my statement to the provision that is of most interest and concern to the rental housing industry and that is the automatic stay provision. As you are well aware, Section 362 of the Code essentially commands that all collection efforts by creditors should cease upon the filing of a bankruptcy petition. For the rental housing community, this prevents the continuation of an eviction proceeding. While the purpose of the automatic stay provision, "to give the debtor a breathing spell from his creditors", is laudable, the rental housing industry and renters in general are disproportionately disadvantaged by this provision, especially when it is manipulated by those who "game the system" simply for personal gain. For over ten years, hundreds of apartment operators, mostly small businesses, have written to the National Bankruptcy Review Commission and Congress, and provided persuasive evidence of the need for reform. I am attaching for your review some of these examples. (Attachment A). According to a recently released report by the Administrative Office of the U.S. Courts, non-business or personal bankruptcy filings remain at "historic highs." The latest data show that well over 1.5 million personal bankruptcy petitions were filed in the twelve-month period ending September 30, 2004.

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When a person files for bankruptcy protection, most of his or her creditors, while not being able to pursue past debts, have no obligation to continue extending credit. However, if the person is renting an apartment, the owner not only forfeits the ability to pursue past rent, the apartment owner must involuntarily continue to extend credit to someone who has no intention of or apparent ability to make payments. At the same time, the apartment owner must continue to pay his or her monthly costs associated with maintaining the unit. In addition, the owner is prevented from renting the occupied apartment to a new resident, further increasing the financial burden. A rental unit is much like a perishable product. Unless an owner can regain possession in a timely manner and place the unit back into service, its value is diminished. For small apartment owners in particular, such situations cause serious financial hardship. Consumers are harmed as well, because for every unit that is taken off the market due to these abusive situations, the availability of rental housing is reduced, not a small problem in a state like California.

The Eviction Process

I am proud of my work in the housing industry and feel a deep satisfaction that I have made it my life's goal to put people into housing. Most of the time this is a tremendously rewarding experience. Unfortunately, there are times when it becomes necessary to remove a resident from his or her rental unit through the eviction process. This is not an easy decision and in most cases, it is one that is reached only after exhausting all other options. When it becomes necessary to take such action, we do so by following state eviction laws and procedures, which we believe to be fair and fully protective of the resident.

Today, residents are well served by state and local eviction procedures that already provide numerous due process protections. Many states make housing providers go through very onerous and costly procedures before an eviction can occur. The owner cannot simply change the locks or take possession of the premises. A court order or a voluntary surrender of the premises by the resident is required before a resident can lawfully be evicted. As a result, there are numerous legal matters that can and do occur as a result of the filing of an eviction case against a resident. Customarily the court gives the resident time to move out, usually one to four weeks. If the resident remains after that period, the owner has to hire the sheriff or marshal to carry out a forcible eviction. That will take several weeks more. Further delays are possible if the resident files a motion for more time or objects to the court determination.

On average, this process can take approximately three months. During these three months, rent is not being paid, the potential for property damage increases, and I am unable to rent the unit to another party. I am also incurring legal bills associated with the eviction process as well as paying the ongoing utilities associated with that unit. Once I have been granted judgment in state court forfeiting a resident's right to possession, if the resident invokes a bankruptcy filing, the "automatic stay" provision of the bankruptcy code stops this process in its tracks. As a result, the resident is permitted to remain in the apartment rent-free for what could be several additional months. It is most absurd in situations where the owner is aware of illegal drug use and property destruction but nonetheless is prevented from regaining possession of his or her property.

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"Eviction Mills" Exacerbate the Problem

What we have found is that in many of these situations, filings are made just so a debtor resident can avoid paying rent. What is even more distressful are the business practices of some unscrupulous opportunists who exploit the automatic stay provision by actively soliciting business from residents facing evictions. These entities research pending eviction cases and then market their services directly to these residents. For a nominal fee, they offer to file various frivolous motions with the court to temporarily halt the eviction proceeding. Once those efforts are exhausted, a bankruptcy petition is then filed, thus stalling eviction for several additional months.

These abusive scenarios are played out all across the country and in all types of properties, large multifamily communities as well as the small property owner renting out a duplex or a garage apartment. It should be noted that the latest data show that nearly 47 percent of all rental housing properties are owned by individuals. Thirty-five percent of all rental apartments are located in properties with fewer than ten units. The added expense and liability of these abuses negatively impacts the availability of rental housing, especially low- and moderate-income housing. Clearly this was not the intent of the automatic stay provision and the negative consequences of such abuse require immediate attention.

Section 311 provides a balanced solution for business and consumers

Section 311 of S. 256 represents a much-needed yet balanced step toward improving the automatic stay for the benefit of rental housing providers and residents alike. While it does not exempt rental housing from the automatic stay provisions, it goes a long way toward offering much-needed protection against abusive practices.

Specifically, section 311 denies an automatic stay of a real property eviction in the following scenarios:

1) When an owner or manager obtains a judgment for possession prior to the date the resident filed a petition for bankruptcy. This is a significant improvement over current law, which rewards those who simply file a petition with the court clerk without regard for the rigorous process already followed by the property owner to rightfully regain possession of his or her property.
2) When the property is endangered or illegal use of controlled substances is taking place on the property. The owner will be required to file a certification statement with the court. This is another improvement over current law which offers little or no protection to an owner facing potential destruction of the property and unlawful activity.

Section 311 also provides additional protection to the resident who wishes to cure the entire monetary default thus enabling the resident to stay the eviction, provided specific requirements

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are met. As mentioned earlier, housing providers typically attempt to work out situations with their residents before they become larger problems. If an eviction can be avoided, all parties benefit.

While there will always exist opportunities for abuse by those seeking ways to exploit the system, it is important that we take the necessary steps to reduce those opportunities while still protecting the resident. Section 311 will go a long way toward curbing some of the more egregious abuses faced by rental apartment providers.

On behalf of NMHC/NAA, I thank you for the opportunity to present our position on these important issues. I urge the members of this Committee and the entire U.S. Senate to pass S. 256 this year and close the automatic stay loophole. This will not only ensure the viability of small business rental housing providers but also help to preserve the affordable and market-rate housing they provide. I thank you for your time and look forward to answering any questions.

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ATTACHMENT A

I. An Army Colonel leased his home to a couple with three small children while he was stationed overseas. Before leasing the property, the firm that managed the Colonel's property ran a credit check and found that the couple had a joint income well in excess of the monthly rent. There was nothing in the credit report to indicate what the Colonel and his family would face over the next two years.

Over the course of the lease term, the residents occasionally made late payments, but their rent was always paid. Eventually, however, the residents failed to pay their rent despite several notices. After the management firm sent them a three-day notice to vacate for non-payment of rent, the firm decided to give the residents yet another chance to work out a repayment schedule.

What the management firm representatives found when they approached the house was shocking: It was in shambles. The oven door had been ripped off its hinges; there were large and numerous holes in the sheet rock, some with silk flowers stuck in them; you could not tell what color the carpet was due to the trash and food strewn on it; the toilet in the upstairs bathroom had been ripped out of the floor; the air conditioning compressor was in pieces; several windows were broken; and the downstairs bathroom door had been kicked in and was hanging by one hinge. The management firm gave the residents a final three-day notice to vacate for non-payment of rent. The residents never responded to that notice, and after the required three-day notice period, the managers filed for eviction.

Even after the eviction filing, the residents failed to pay their rent. Finally, a judge granted the eviction and ruled that the residents would have to pay all overdue rent. The residents then claimed that they were financially unable to post the required bond to appeal. At a hearing on that claim, the judge confirmed that the residents had both the income and the assets to post the appeal bond and granted the management firm a writ of possession. The next day, however, the managers were notified that the residents had filed for bankruptcy, effectively stopping the eviction process because of the Code's automatic stay provision.

Following multiple failed attempts to negotiate a settlement, the management firm filed for relief from the automatic stay. The residents then demanded a hearing on that motion. During the three-month period before the hearing, the residents lived in the house rent-free. Seven months after the ordeal began, and four months after the bankruptcy court assumed jurisdiction, the judge agreed to a settlement that directed the residents to move out and repair all damages. When the residents had not moved out in accordance with the settlement, the court issued another writ of possession for the next day. Finally, the resident's possessions were removed from the house and their bankruptcy petition was dismissed. The overall cost to the Colonel (the owner of the property) was approximately $21,000. By the time the residents were finally evicted, the Colonel had to borrow on his life insurance, sell assets, and run up the balance on his credit cards. When the house was sold shortly thereafter, the Colonel received nothing.

II. Sheri Perez, an owner of eight rental units in Costa Mesa, CA, had renters in two of the units declare bankruptcy in the same month. "I know for a fact that these two tenants used the automatic stay and filing bankruptcy just to get out of paying any rent," she wrote to the National Bankruptcy Review Commission. Each of the renters owed two months' rent when they moved out – 25 percent of Ms. Perez's entire rental income for those months.

III. Dan Snell, a property owner in Temple City, CA who manages 50 rental properties, recounted the loss sustained on a 10-unit property he manages in his letter to the National Bankruptcy Review Commission. A resident who was being evicted for selling drugs on the property declared bankruptcy. Before the bankruptcy court ordered relief from the automatic stay to permit Mr. Snell to remove this drug-seller, Mr. Snell had to wait two months for the court to permit the eviction to proceed. "During that period," wrote Mr. Snell, "the tenant continued his illegal activities and three of the other tenants moved out because of that activity. This episode cost the owner several thousand dollars in legal fees and lost rent."

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Statement of Senator Joseph R. Biden, Jr.
Hearing on Bankruptcy Reform
Committee on the Judiciary
United States Senate
February 10, 2005

Thank you, Mr. Chairman.

I look at my friend Chuck Grassley, and think about the eight years and more that he has been working on this legislation. A lot of us in this room have worked on this over the years. Time and again, in Congress after Congress, somehow we have seen defeat snatched from the jaws of victory.

Bills that have passed both Houses by wide bi-partisan margins have died in conference after conference. President Clinton pocket-vetoed one bill that enjoyed veto-proof majorities in both houses. And here we are again.

S. 256, the subject of this hearing today, is the result of those years of work. Literally hundreds of amendments have been offered, debated, and voted on, here in the Judiciary Committee and on the Senate floor. I can't say I have enjoyed every minute of it, but it was not time wasted. This is important, and we should do all we can to get it right.

Very few bills have had the scrutiny – and the

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repeated bi-partisan support – that this legislation has had over the years. It has been controversial, there is no denying that.

But look at the votes for final passage, on essentially this approach to reform, in the 107th and 106th Congresses. In 2001, the Senate voted 86 - 16 in favor of this version of reform – with one significant exception – the Schumer amendment – that I will speak to in a moment. That year, the House vote was 306 to 108. In the previous Congress, similar legislation passed the Senate 83 to 14; the House vote was 313 to 108.

I hope we all remember those votes when we revisit this legislation this year. I know we will hear from those who disagree with those votes, who do not agree with this approach to bankruptcy reform. I respect those views, and I respect the motivation behind them.

But I disagree that this legislation is unfair. We have some significant new protections for child support and alimony in bankruptcy, closing some glaring gaps in current law. Mr. Strauss is back before us to speak to those provisions, supported by child support authorities around the country.

For the first time we have an objective test of filers' ability to pay – to make sure that a Chapter 13 filing, and not liquidation of all their assets – is the right place for them. And we exempt anyone under the median income in their state from the means test that determines their

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ability to pay.

There are new requirements on lenders to be more honest and transparent about the terms of their loans. Credit card companies must warn their customers about the cost of making minimum payments.

This is not an institution designed to produce perfection. Our founders did, however, intend our legislative process to produce consensus.

Those overwhelming votes, and the history of bipartisan debate and amendment over several Congresses, tell me we have reached consensus.

The last time the Senate considered this legislation, Senator Leahy, Senator Schumer, and I signed a conference report identical to the bill before us today – again, with the one important exception that this bill lacks the Schumer amendment.

We said, with those signatures, that this bill was ready to become law. We said, with those signatures, that bipartisan, balanced bankruptcy reform was ready for the President's signature. I think that is still true today.

With one exception.

In the 107th Congress, we heard from Ms. Vullo, who is with us here again today, that those protected by the Fair Access to Clinic Entrances Act deserve the same

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treatment that we provide for others who are owed legitimate debts. They should be repaid. No favoritism, no discrimination.

That is why Senator Schumer and I found ourselves, months later, locking horns with our House counterparts, until we could agree on language that made sure that would happen. We succeeded. I want this Committee to know, and Senator Schumer to know, that I will do everything I can this time around to reach that same result.

But, Mr. Chairman, with that one key exception, this bill is ready to become law. I will have an amendment bringing up to date the number of bankruptcy judgeships needed around the country, nowhere more than in my state of Delaware. The current provision is now several years out of date.

I will insist that we have a fair hearing for amendments, as I expect we will have here, Mr. Chairman, and as I hope we will have on the Senate floor. But at some point, the talk must end and we must vote, as we have so many times before.

We have seen broad, bipartisan consensus on bankruptcy reform for years. I expect we will see it again this time.

Thank you, Mr. Chairman.

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LAW OFFICES OF RICHARD R. CLEMENTS
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February 9, 2005

By facsimile (202)228-2281
and regular mail)

Senator John Cornyn
Room 517, Senate Hart Office Bldg.
Washington, D.C. 20510

Re: "Fairness of Bankruptcy Litigation Act of 2005",
S_____.

Re: "Bankruptcy Reform Legislation", S.256.

Dear Senator:

I have practiced Bankruptcy Law, as a specialty, for approximately 44 years, serving in approximately all capacities in the Bankruptcy Court as an advocate, as a trustee in bankruptcy, as a receiver (under the Pre-1978 Bankruptcy Act), and I write both in support of your proposed amendment to the venue provisions of Section 1408 of Title 28, United States Code and also to urge your opposition to various provisions of the Bankruptcy Reform Legislation filed approximately February 1, 2005 by Senator Grassley (S.256).

I believe that your "Fairness in Bankruptcy Litigation Act of 2005" is badly needed and will serve to even the playing field with the favorable result (in my opinion) of most major cases being sited at the court most usually convenient to the majority of the participants of the case including consumers, shareholders, and small to mid-level creditors. Recently this forum-shopping practice has become so pervasive that local firms in the Central District of California have opened branch offices in Delaware and New York. I believe that your proposal truly strengthens the credibility of the bankruptcy system and will substantially reduce the potential for conflicting decisions of the Federal Appellate Courts in the Second and Third Circuits as opposed to the remaining Circuits nationwide.

Conversely, I would invite your attention (with an eye to reform) urging modification of the Bankruptcy Reform Legislation S.256) just introduced by Senator Grassley which (1) substitutes the debtor's actual expenditures for a "means test" based on

Senator John Cornyn
Page 2
February 9, 2005

objective standards akin to IRS standards; and (2) would require debtor's attorneys to certify the accuracy of the debtor's bankruptcy schedules under penalty of harsh court sanctions and also require them to identify and advertise and conduct themselves as "debt relief agencies" subject to a host of new intrusive regulations.

While this office does as much work representing creditors, bankruptcy administrators such as trustees, various bankruptcy committees, as it does representing debtors, the inclusion of these respective provisions in a bill that has some very good qualities (for example, the chapter respecting international bankruptcies) the offending provisions seem to be totally without merit, and an attempt to punish the financially distressed and to deny them their "fresh start" in the bankruptcy context as well as deny them representation.

It is my understanding that the Senate Judiciary Committee may hold hearings on S.256 tomorrow (February 10). While I believe the reform proposed in your Bill is true reform, implementation of Senator Grassley's offending provisions would increase the time of bankruptcy judges that is desperately needed for the handling of legitimate issues as opposed to make believe problems imposed to deny debtor's their "fresh start" as envisioned by the framers of the United States Constitution.

I note, in one of the news articles, that your proposed legislation is cited with approval by Professor Elizabeth Warren, of Harvard Law School. I would urge that you seek her opinion, as an additional source, concerning S.256.

Sincerely,

RICHARD R. CLEMENTS, OF
RICHARD R. CLEMENTS PROFESSIONAL CORPORATION

RRC:cb

cc: By facsimile to Professor Elizabeth Warren (617)496-6118

COMMERCIAL LAW LEAGUE OF AMERICA®

February 7, 2005

The Honorable John Cornyn
United States Senate
Washington, DC 20510

Dear Honorable Cornyn:

The Commercial Law League of America ("CLLA"), founded in 1895, is the nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the field of commercial law, bankruptcy and reorganization. Its membership exceeds 3,500 individuals. The CLLA has long been associated with the representation of creditor interests, while at the same time seeking fair, equitable and efficient administration of bankruptcy cases for all parties in interest.

The Bankruptcy Section of the CLLA is made up of approximately 1,100 bankruptcy lawyers and bankruptcy judges from virtually every state in the United States. Its members include practitioners with both small and large practices, who represent divergent interests in bankruptcy cases. The CLLA has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization fields.

A principal concern of the CLLA is the need for an amendment requiring that the domicile and residence for venue of corporate debtors be conclusively presumed to be the location of the debtor's principal place of business without regard to the debtor's state of incorporation. Such a change would benefit creditors and prevent an unacceptable degree of forum shopping by debtors who are in search of a venue that will be friendly to their needs. More important, however, requiring that a corporate bankruptcy take place locally ensures that the distinct needs of the community are not overlooked.

Allowing the practice of forum shopping by debtors undermines the bankruptcy process and creates unwarranted competition among the courts. Before filing, the debtor is able to determine which courts have taken friendly views of the debtor's particular needs and select such a court with the intent of creating a disadvantage for creditors. Indeed, some corporate debtors have even commenced bankruptcy cases in preferred venues by strategically creating or using otherwise healthy subsidiaries to create a basis for filing in the intended court. Current law as written fosters these abuses

The CLLA strongly supports passage of the Fairness in Bankruptcy Litigation Act of 2005 (the "Act") since the proposed legislation addresses these abuses. The Act will help to eliminate the forum shopping that skews the bankruptcy process and will foster greater local control over important business and community decisions. Although the

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Act may require some technical modifications to achieve and address the legislation's purported goals, its overall provisions and goals are well grounded and supported by the abuses taking place within the bankruptcy system.

Much has been said among members of Congress that bankruptcy reform is necessary to prevent what it perceives as abuse of the bankruptcy process. A venue provision that requires corporate bankruptcies to be filed at the principal place of business furthers that goal and for all these reasons we encourage the passage of the Act at the earliest opportunity.

Respectfully submitted,
Commercial Law League of America

Mary K. Whitmer
President
Commercial Law League of America

Alan I. Nahmias
Chair, Bankruptcy Section
Commercial Law League of America

Jay L. Welford
Co-Chair, National Governmental
Affairs Committee
Commercial Law League of America

Judith Greenstone Miller
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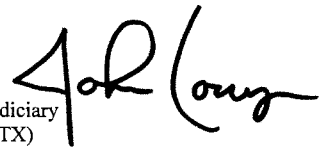

U.S. Senate Committee on the Judiciary
U.S. Senator John Cornyn (R-TX)

"Bankruptcy Reform"

S. 256, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Grassley)
S. 314, Fairness in Bankruptcy Litigation Act of 2005 (Cornyn)

Thursday, February 10, 2005, 10:15 a.m.
Dirksen Senate Office Building Room 226

Thank you, Mr. Chairman, for convening today's hearing. I also want to thank Senators Grassley and Biden for their hard work and leadership over the last several years to reform our federal bankruptcy laws.

I support bankruptcy reform, because I believe that we need to restore a greater sense of personal responsibility to our financial system and to prevent the abuses of the bankruptcy law that we have witnessed in recent years. Bankruptcy relief should be available to those who are *unable* to pay – not to those who are simply *unwilling* to pay.

I also believe that we must do more to combat forum shopping in our courts. Forum shopping is wrong. It distorts and corrupts our justice system. Because picking the judge isn't far off from picking the verdict.

So I'm glad that we're working now on the floor of the United States Senate to combat forum shopping in the area of class actions. And I believe that we need to undertake similar steps to prevent forum shopping in the area of bankruptcy law.

Earlier this week, I introduced new legislation entitled the **Fairness in Bankruptcy Litigation Act of 2005**. The bill would provide much-needed protection – for consumers, creditors, workers, pensioners, shareholders, and small businesses – by reforming the rules governing venue in bankruptcy cases to combat forum shopping. It would prevent corporate debtors from moving their bankruptcy cases thousands of miles away from the communities and their workers who have the most at stake. And it will prevent bankrupt corporations from effectively selecting the judge in their own cases.

That's exactly what happened in the Enron bankruptcy litigation. I tried to steer that case towards federal court in Houston, when I served as Texas Attorney General. But because of current law, that litigation was instead adjudicated in New York – where Enron reportedly employed fewer than 60 employees.

Forum shopping and abuse of our bankruptcy venue law is a real problem. That problem has been well documented by our nation's leading bankruptcy experts – including most recently in a comprehensive book published just last week by UCLA Law **Professor Lynn M. LoPucki**, entitled ***Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts***, as well as by **Professor Jay L. Westbrook** of the University of Texas Law School – a school that of course holds a special place in my heart.

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I am pleased to say that, although the bill was introduced just two days ago, it has already garnered strong, widespread support. For example, the bill is supported by **Texas Attorney General Greg Abbott, a Republican,** and **former Massachusetts Attorney General Scott Harshbarger, a Democrat**. The bill is also supported by major national bankruptcy organizations like the **National Association of Credit Management** and the **Commercial Law League of America**. Because my bill will help small businesses, the **National Federation of Independent Business** supports it. The bill has earned the support of numerous prominent bankruptcy law professors and practitioners nationwide, including many from my home state of Texas. And it is especially important to me, in light of the many Texans who were hurt by the Enron corporate scandal, that this legislation is endorsed by **representatives of the Enron Employees Committee**. I ask unanimous consent that all of these endorsement letters be entered into the record.

Notably, **the October 1997 report of the National Bankruptcy Review Commission** overwhelmingly endorsed bankruptcy venue reform. That's why my bill is supported by **Brady Williamson**, who served as chairman of the commission. Bankruptcy venue reform was also endorsed by commission member and bankruptcy expert **U.S. Circuit Judge Edith Jones of Houston, Texas**, as well as by **Harvard Law Professor Elizabeth Warren**, who I'm pleased to see here today, and who served as the reporter for the commission. Anyone who knows anything about bankruptcy knows that getting consensus from Mr. Williamson, Judge Jones, and Professor Warren is really quite an achievement.

Mr. Chairman, I ask unanimous consent that my statement today, and my floor statement earlier this week introducing the legislation, be entered into the committee hearing record. And I look forward to working with my colleagues on this legislation to provide much-needed protection – for consumers, creditors, workers, pensioners, shareholders, and small businesses – by reforming the rules governing venue in bankruptcy cases to combat forum shopping.

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U.S. Senate Committee on the Judiciary
U.S. Senator John Cornyn (R-TX)

Fairness in Bankruptcy Litigation Act of 2005

Tuesday, February 8, 2005

Mr. President, I rise today to introduce the Fairness in Bankruptcy Litigation Act of 2005.

This legislation will provide much-needed protection – for consumers, creditors, workers, pensioners, shareholders, and small businesses – by reforming the rules governing venue in bankruptcy cases to combat forum shopping.

Quite simply, my bill will prevent corporate debtors from moving their bankruptcy cases thousands of miles away from the communities and their workers who have the most at stake. And it will prevent bankrupt corporations from effectively selecting the judge in their own cases – because picking the judge isn't far off from picking the verdict.

This Act is a positive step for fairness, responsibility, and justice. It implements a major recommendation from the October 1997 National Bankruptcy Review Commission report, and has earned the support of prominent bankruptcy law professors and practitioners nationwide. The bill is also supported by Texas Attorney General Greg Abbott (R) and former Massachusetts Attorney General Scott Harshbarger (D); Brady C. Williamson, who served as chairman of the National Bankruptcy Review Commission; and major national bankruptcy organizations like the National Association of Credit Management and the Commercial Law League of America. I ask unanimous consent that these endorsement letters be entered into the record at the close of my remarks.

With the introduction of this Act, this body will now have an opportunity to consider this growing crisis, which effects so many consumers and workers, just as we are about to examine the issue of comprehensive bankruptcy reform.

Sadly, our current bankruptcy venue law has become a target for enormous abuse. It's a problem that is well documented by academics, most recently in a comprehensive book published just last week by UCLA Law Professor Lynn M. LoPucki, as well as by Harvard Law Professor Elizabeth Warren, who served as the reporter for the National Bankruptcy Review Commission, and Professor Jay L. Westbrook of the University of Texas Law School.

I have personal experience with the worst kind of forum shopping. During my service to the state of Texas as Attorney General, I argued that the Enron federal bankruptcy court proceedings should be litigated in Houston. That seemed like the common sense argument, of course – after all, Houston was where the majority of employees and others who were victimized by that corporate scandal called home.

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Yet that's not where the case ended up. Instead, Enron was able to exploit a key loophole in bankruptcy law to maneuver their proceedings as far away from Houston as possible. They ended up in their desired forum in New York. *See In re Enron Corp.*, 274 B.R. 327 (S.D.N.Y. Bankr. 2002).

Enron used the place of incorporation of one of its small subsidiaries in order to file a bankruptcy claim in New York, and then used that smaller claim as the basis for shifting all of its much larger bankruptcy proceedings into that same court. The company had 7,500 employees in the Houston headquarters, but they filed for bankruptcy in New York, where Enron had only 57 employees.

This kind of blatant forum shopping makes a mockery of our laws. The common-sense legislation that I've introduced today will combat such egregious forum shopping by requiring that corporate debtors file where their principal place of business or principal assets are located (rather than their state of incorporation), and forbidding parent companies from manipulating the venue by filing first through a subsidiary.

Bankruptcy venue abuse is not just bad for our legal system; it hurts America's consumers, creditors, workers, pensioners, shareholders, and small businesses. Under current law, corporate debtors effectively get to pick the court in which they will file for bankruptcy. As a result, creditors can be forced to litigate far away from the real-world location, where costs and inconveniences associated with travel are prohibitive.

This troubling loophole also serves to unfairly enable corporate debtors to evade their financial commitments. It badly disables consumers, creditors, workers, pensioners, shareholders, and small businesses from pursuing and receiving reasonable compensation from bankruptcy proceedings.

Current law allows debtors to forum shop and thereby to pick jurisdictions likely to rule in their favor. If debtors get to pick the jurisdiction, then bankruptcy judges have a disturbing incentive to compete with other bankruptcy courts for major bankruptcy cases, by tilting their rulings in favor of corporate debtors and their attorneys.

The examples are numerous. Here are three of the most prominent incidents:

- **Polaroid.** In October 2001, **Boston**-based Polaroid filed for bankruptcy in **Delaware**, listing assets at $1.9 billion. Polaroid's top executives claimed that the company was a "melting ice cube," and arranged a hasty sale for $465 million to a single bidder. The court refused to hear testimony as to the true value of the company and closed the sale in only 70 days. The top executives went to work for the new buyer and received millions of dollars in stock. Meanwhile, disabled employees had their health-care coverage cancelled. The so-called "melting ice cube" became profitable the day after the sale became final.

- **K-Mart.** In January 2002, failed top executives delivered **Michigan**-based K-Mart to the bankruptcy court in **Chicago**, which reportedly had been actively soliciting large

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corporate debtors to file there. With a workforce of 225,000, K-Mart had more employees than any company that had ever filed bankruptcy nationwide. The Chicago judge let the failed executives take tens of millions of dollars in bonuses, perks, and loan forgiveness. Bankruptcy lawyers also profited, pocketing nearly $140 million in legal fees. But some 43,000 creditors received only about ten cents on the dollar.

- **Worldcom.** Worldcom perpetrated one of the biggest accounting frauds in history, inflating its income by $9 billion. Although based in **Mississippi**, Worldcom followed Enron into the **New York** bankruptcy court, where its managers received the same lenient treatment. No trustee was appointed; indeed, five months after the case was filed, the directors in office when the fraud occurred still constituted a majority of the board. They chose their own successors. A Top Worldcom executive used money taken from the company to build an exempt Texas homestead, and Worldcom took no action. That executive then used the homestead to buy his way out of his problems with the SEC. Meanwhile, creditors – mostly bondholders – lost $20 billion.

This is not the first time we have addressed this important issue. The House Judiciary Subcommittee on Commercial and Administrative Law held a hearing on July 21, 2004, entitled "Administration of Large Business Bankruptcy Reorganizations: Has Competition for Big Cases Corrupted the Bankruptcy System?," and Congressman Brad Sherman (D-CA) has previously led efforts to champion bankruptcy venue reform in the House. During the 107th Congress, Senator Durbin introduced S. 2798, the Employee Abuse Prevention Act of 2002, joined by Senators Kennedy, Kerry, Leahy, and Rockefeller, while Congressman William D. Delahunt (D-MA) introduced the same bill in the House; section 205 of that legislation would have reformed the bankruptcy venue law.

Mr. President, I believe we must take steps to respond to this important problem. The American people deserve better from our legal system. All bankruptcy cases deserve to be handled fairly and justly, and no corporate debtor should be allowed to escape responsibility by fleeing to another venue. It is high time that we take up this much-needed reform.

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CORINNE COOPER
1323 E. Renfrew Place
Tucson, AZ 85719

January 31, 2005

Dear Senator Cornyn:

I am writing to you to support your effort to pass a bill that would prevent corporations from shopping for the most favorable venue. The current practice has resulted in a "race to the bottom" as bankruptcy courts work hard to lure corporate bankruptcies to their courts.

I was a professor at the University of Missouri—Kansas City School of Law for almost 20 years. My own worst example is the case of Birch Telecom, a Kansas City-based company that filed in Delaware in 2002. After laying off a quarter of their employees—citizens of Missouri, Kansas, and Texas—Birch went into bankruptcy with a prepared plan (known as a "pre-pack") that included significant compensation for the very officers who had led the company into bankruptcy.

A bankruptcy judge from Texas, sitting by designation (because of the volume of cases being filed in Delaware) had the audacity to suggest that he might not approve the plan because of the compensation package. Before his words were out of his mouth, Birch Telecom's attorneys had appealed the reference of the case to that judge. The case was withdrawn, and a Delaware judge, who understood that the game is appeasing the corporate debtors, approved the plan 13 days later.

What possible chance do employees and local creditors have when a distant bankruptcy judge will rubber-stamp the company's every request, in a court too far away for them even to appear?

Congress says that it is trying to stop bankruptcy abuse. Venue shopping is the very worst example of bankruptcy abuse, and it affects the lives of thousands

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of ordinary Americans—employees and small businesses—every single day.

I wish you good luck in the passage of this important piece of legislation.

Sincerely,

/s/ Corinne Cooper
Corinne Cooper
Professor Emerita of Law

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February 4, 2005

Senator John Cornyn
517 Hart Senate Building
Washington, D.C. 20510

Re: Proposed Bankruptcy Legislation/Venue

Dear Senator Cornyn:

One of the issues being discussed in connection with proposed bankruptcy legislation is in what venue or venues is it most appropriate for business debtors to initiate voluntary bankruptcy cases, where they conduct their daily business or there they were incorporated.

Because a corporation (or any other type of business organization) seeking bankruptcy relief should do so in a forum that is convenient for itself, its management, its employees and its creditors, Section 1408 of Title 28 of the U.S. Code should be amended to prohibit the right of a debtor corporation to file in the state of its incorporation unless it either has its principal place of business or its principal assets in that state.

The reason for requiring a debtor to seek relief in a bankruptcy court nearest to its actual place of operation is that, otherwise, the rights of the other parties are significantly and adversely affected because of the distance, delay and costs of dealing with a faraway court.

The practice that has developed over the years is that corporations, for example those created under the laws of Delaware, file in Delaware, far from their actual places of business, Texas for example, thus causing their management, employees and creditors to have the burden and expense of travel, to hire distant counsel with whom they have had no prior experience, or both, in order to protect their interests. Many times, at least from a creditor/employee perspective, the inconvenience and expense, when balanced against the probability of an insignificant recovery on a claim, is such that creditors/employees simply abandon their claims, a result which is contrary to the spirit and intent of the Bankruptcy Code.

Senator John Cornyn
February 3, 2005
Page 2

As a bankruptcy practitioner for over 40 years and one who is active in various bankruptcy organizations, I urge you and your staff to consider the thoughts expressed in their letter.

As the grandfather of Richie Anderson who served as an intern on your staff last summer, I know, from his experience, that you will listen to the opinions of your constituents.

Yours very truly,

L. E. Creel, III

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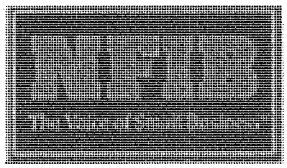

February 9, 2005

The Honorable John Cornyn
U.S. Senate
517 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Cornyn:

On behalf of the 600,000 members of the National Federation of Independent Business (NFIB), I am writing in support of your bill to protect small business owners by reforming the rules governing venue in bankruptcy and thereby bring cases closer to the small businesses involved in the proceedings.

Under current law corporate debtors often get to pick jurisdictions that will likely rule in their favor. This can mean that the bankruptcy proceeding is held thousands of miles away from the communities where the corporation's business is based. In order to protect itself, a small business seeking compensation has to hire legal representation, and usually an out-of-state attorney as well, to represent them in the proceeding. Small business owners, who often operate on slim profit margins, should not have to face excessive legal bills when trying to receive compensation from large corporations who have filed for bankruptcy.

While small businesses will still have to defend their transactions to the bankruptcy court, your bill is a great help in lessening the financial burden that the federal bankruptcy code places on innocent small businesses.

Sincerely,

Dan Danner
Sr. Vice President
Public Policy

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Statement of Senator Richard J. Durbin
Senate Judiciary Committee
Hearing on S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act
February 10, 2005

Thank you, Mr. Chairman. I appreciate your willingness to schedule today's hearing before launching into a markup of this 501-page bill.

The bankruptcy debate has moved around the Congressional stove – from high boil to low simmer – for eight years now, but it has been four years since this Committee conducted a hearing on this bill.

Much has changed in four years. Our nation was attacked by terrorists. We endured a prolonged recession. A wave of corporate scandals shook our economy, leading to massive layoffs and ravaged pensions and 401(k) plans. Large corporate bankruptcies left workers and retirees across the country with reduced wages, crippled pensions plans and significantly reduced health benefits.

All of those things happened since the last time this Committee considered this bill.

One thing that didn't happen last year is also worth noting. Despite the fact that these continue to be hard economic times for many Americans, personal bankruptcies did not increase. In fact, the number of Americans filing for bankruptcy actually declined slightly last year.

That raises an interesting question: If bankruptcies are declining, what is the rush? Why are we in such a hurry to pass this bill?

The banks and the big credit card companies -- which stand to make billions from this bill -- will tell you it is needed to stop greedy people who game the system and refuse to honor their debts, even though they can afford to pay them.

That characterization is cruel and it is false.

We are fortunate to be joined today by Professor Elizabeth Warren of Harvard Law School. Professor Warren is the author of the new study examining the relationship between bankruptcy and medical debt. The findings of her study ought to give us all pause.

Professor Warren's study found that the average bankruptcy petitioner is a 41-year-old middle-class woman with children and at least some college education. The median income of those filing for bankruptcy protection is $25,000 per year, and almost half of the people who file for bankruptcy do not own a home.

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These are middle-class families who have done everything they're supposed to do and suffered a serious financial setback. They may have lost a job or been divorced. Even more likely, they or someone in their family has suffered a serious illness or injury and needed expensive medical care that wasn't covered by insurance.

Half of all the bankruptcies in this country are the result of medical debt. Even more shocking, in three-quarters of those bankruptcies, the people actually had health insurance; they were bankrupted by uncovered medical costs.

Families with children were especially hard hit. About 700,000 children live in families that declared bankruptcy because of medical debt.

These are dignified people who have tried hard to avoid bankruptcy. Professor Warren's study found that in the two years before filing for medical bankruptcy, 22 percent of families had gone without food, 30 percent had had a utility shut off, 61 percent had gone without needed medical care, and 50 percent had failed to fill a needed prescription. To demonize these struggling souls is unconscionable.

I am particularly concerned about the harm this bill could cause military families, especially members of the Guard and Reserve and their families. Forty percent of the troops serving today in Iraq and Afghanistan are members of the Reserves and National Guard. Many have been deployed for a year or more since 9/11. Some are on their second tour of duty.

These are citizen soldiers who have left behind other lives and other jobs that paid more than their military wages. It's not unusual that their income is cut in half.

Now, a lot of us could probably get by on half our income for a month or so – but how many of us could get by on half of our income for a year or more? Some Guard members and Reservists who are entrepreneurs are losing their businesses. And an increasing number are in danger of bankruptcy.

We had hoped to hear today from a Reservist who is a co-owner of a restaurant. He and his business partner have both been called to active duty since 9/11. He has had to file for bankruptcy and is in danger of losing the business.

I believe it's wrong to ask military families to take such drastic cuts for such extended periods. I will be reintroducing the Reservist Pay Security Act, a bill to ensure that federal employees who are members of the National Guard or Reserves continue to receive the difference between their civilian pay and their military pay when they are called up for active duty. We ought to lead by example. If you're on foot patrol in Baghdad, the last thing you should have to worry about is whether your family is going to end up destitute.

I also continue to be deeply troubled by another aspect of this bill, that is the "minimum payment" trap that ensnares many families in perpetual debt. People are

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encouraged to pay just a fraction of their debt each month, while the bulk of the debt continues to collect interest and grow.

Consumers need to know exactly how much making only minimum payments actually costs in additional interest. I've been working with Senator Akaka and others on a bill that would require lenders to spell out clearly how long it will take to pay off a debt making minimum payments only, and how much it will cost in interest.

We know who will suffer most if this bill passes: hard-working, middle class families, especially those with children.

Who stands to gain? Some of the most profitable industries in America today: credit card companies and banks. In 2003, credit card companies enjoyed a $30 billion profit – their highest profits in 15 years.

If credit card companies were truly concerned about limiting their bankruptcy losses, you would think they would issue fewer credit cards to families in difficult financial circumstances. In fact, just the opposite is true. Some credit card companies take advantage of these people by offering them additional credit cards loaded with outrageous fees and exorbitant interest rates. Late fees are 2.5 times higher than they were just a decade ago - and still going up. The average late fee is now over $31 and some run as high as $49. Late fees now represent the third-largest source of revenue for credit card issuers.

There is more than one way to build a debtor's prison. You can build a debtor's prison with bricks-and-mortar, or you can build it with unjust laws that deny people hope of ever paying off their debt, no matter how they acquired it, or how hard they work to get rid of it. That is what this bill, in its current form, would do for many middle-class families. And make no mistake, as medical costs continue to soar, more and more Americans will find themselves in this situation.

I am glad we are having this hearing; I hope it is not our only hearing on this bill. Before we make radical changes in our bankruptcy laws, we have a responsibility to make sure the facts justify our actions. At a minimum, I believe we should change this bill to give bankruptcy judges the discretion to exempt from the harsher provisions in this proposal those people who are pushed into medical bankruptcy by catastrophic medical debt.

I welcome our witnesses, and look forward to hearing their perspectives. Thank you, Mr. Chairman.

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News From:

U.S. Senator Russ Feingold

506 Hart Senate Office Building
Washington, D.C. 20510-4904
(202) 224-5323

http://www.senate.gov/~feingold

Contact: **Trevor Miller**
(202) 224-8657

Statement of U.S. Senator Russ Feingold
At the Judiciary Committee Hearing on Bankruptcy Reform

February 10, 2005

Mr. Chairman, I want to welcome our witnesses, particularly Ken Beine from Wisconsin. And I appreciate your holding this hearing rather than taking this bill directly to a markup this week, as was originally planned. Let me respectfully suggest that the testimony we are about to hear makes it very clear that a markup of this bill in this committee next week would be premature. This bankruptcy bill was essentially written in 1998, seven years ago. The last time the Judiciary Committee held hearings or took any action on the bill was in early 2001. It is now 2005. It is simply inconceivable this Committee will be ready next week to do the job that it needs to do on a bill this complex and a topic this important to our economy and the lives of our most vulnerable citizens.

The last significant bankruptcy reform legislation in this country was passed in 1978. This is not a topic that Congress gets back to every few years. We need to do this job right and we need to do it comprehensively. That means addressing the important issues raised by the effect of increasing corporate bankruptcies on the pensions and health care of employees, rather than saying that those issues can wait for another bankruptcy bill sometime in the future. These are pressing issues that this committee must face up to now. And it certainly will not be an acceptable answer to those who point out real problems with how the current bill will operate that we can fix those problems at some later date. So I hope, Mr. Chairman, that this committee will serve its proper role in the Senate to examine legislation carefully and completely before sending it to the floor. And I hope that every member of this Committee, even those who support this bill, will recognize that a real amendment process is appropriate here, in contrast to what we have seen on the class action bill over the past few weeks.

My questions today will highlight some of the problems with S. 256 that practitioners, academics, and trustees have identified. We need to listen to those non-

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partisan experts before we enact this bankruptcy bill or we will do grave harm to a system that is a crucial part of the safety net that the law offers to our most vulnerable citizens.

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Opening Statement of Senator Charles E. Grassley

Mr. Chairman, I'm pleased the bankruptcy bill is on the Judiciary Committee agenda and that we are scheduled to mark up this bill next week. The bipartisan legislation I just introduced as S. 256 is nearly identical to the 107th Congress H.R. 333 Conference Report signed by Senator Leahy, but voted down in the other body. The only difference is that I've removed the poison pill abortion amendment. All of the other compromises made at the request of our Democratic colleagues have been preserved intact in this bill.

As many of you know, we've been working on the issue of bankruptcy reform for a number of years now-since the mid 1990's. When I started working on this issue, it was considered a scandal that bankruptcies might reach 1.4 million. Guess what? In 2004, there were 1.6

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million. Congress has wasted time and we still have a bankruptcy crisis on our hands.

By way of background, both Houses demonstrated overwhelming margins in favor of this bipartisan bill in 2000, but President Clinton pocket-vetoed the legislation and we simply ran out of time in the session to override the veto. In the 107th Congress, I re-introduced the bankruptcy bill and it passed the Senate overwhelmingly, with numerous changes to satisfy Democrats. We then went to conference with the House, and further concessions were made. The conference committee report language was the result of a long process of bipartisan negotiations that culminated in agreement on over four hundred pages of legislative text. Ultimately, we had a signed conference report supported by our Ranking Member.

Given that the language we are considering is the same as the 107th Congress conference report signed off

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on by our Democratic friends - minus the poison pill – I'm hopeful that we can all stand by the compromises we reached in good faith. We all cooperated and compromised on this legislation. It provides new consumer protections, helps children in need of child support, and makes other necessary reforms to a system that is open to abuse. There is no need to re-open this bill.

As we hear from witnesses today, I recall the broad public support for reforming our bankruptcy system. The vast majority of people believe that individuals who file for bankruptcy should be required to pay back some of their debts if they have the means to do so.

This is precisely what the bankruptcy reform legislation does.

Most people think it should be more difficult for people to file for bankruptcy. Americans have had enough; they are tired of paying for high rollers who

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game the current system and its loopholes to get out of paying their fair share.

This legislation eliminates some of the opportunities for abuse that exist under the current system. Our current system allows wealthy people to continue to abuse the system at the expense of everyone else. People with good incomes can run up massive debts and then use bankruptcy to get out of honoring them.

All of us end up paying for the unscrupulous who abuse the system. In fact, it has been estimated that every American family pays as much as $550 a year in a hidden tax as a result of the actions from these abuses. My bankruptcy reform legislation will help eliminate this hidden tax by implementing a means test to make wealthy people who can repay their debts actually honor them. I suppose we can call this a tax cut for the responsible people in America.

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Bankruptcy abuse hurts our nation's small businesses. We will hear today about how small businesses have been hurt by losses due to bankruptcy. When businesses absorb these losses, they have to make up for the loss somehow through higher prices, or by laying off employees or going out of business.

The bankruptcy crisis is a jobs crisis. Making American's businesses stronger helps all of us - especially those in need of a job.

Make no mistake, misrepresentations about this legislation have been running rampant by those who oppose any meaningful bankruptcy reform. I've been in politics a long time, and I know that political criticism is never inhibited by ignorance. For instance, the statistical analysis in the U.S. Trustee's office examined over 5000 bankruptcy cases and found that under one-half listed medical debts of any sort. And those filers who did list

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medical debts, on average, listed under $5000 in medical debts.

So much for the myth that most bankruptcies are driven medical costs. The fact is there are abusers out there. The fact is S. 256 doesn't harm bankrupts with large medical debts.

Let's stop the abuse. Let's return to common sense. Let's enact bankruptcy reform now, before the abuse gets worse.

The reality is that the bankruptcy reform bill does not deny anyone access to bankruptcy relief; it just requires those who have the means to repay debts based on their income to do so. It's that simple. I look forward to quick Committee action and quick floor action on this bill.

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February 7, 2005

VIA HAND DELIVERY

Senator John Cornyn
617 Senate Hart Office Building
Washington, DC 20515

Re: Bankruptcy Venue Reform

Dear Senator Cornyn:

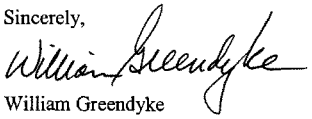
I write you to express my strong support for bankruptcy venue reform. By way of introduction, I have been a partner in the bankruptcy section of Fulbright & Jaworski since June 1, 2004. Prior to that, I served as a United States Bankruptcy Judge in Houston for almost 17 years, resigning as Chief Judge a day before I joined Fulbright.

Over the many years of my judicial career, I watched as many cases which should have been filed in Texas instead found their way to the dockets of courts in Delaware, New York, or some other distant jurisdiction. This migration of large cases is not unique to Texas and it represents a fundamental flaw in the perceived and actual fairness of the bankruptcy system. The "little people" (small creditors, former employees, etc.) in a large bankruptcy case are at once the most vulnerable economically and the parties least capable of participating in a distant forum.

I firmly feel the integrity of today's bankruptcy system requires that the rights of all involved be protected and that fair access to court be ensured. Bankruptcy venue reform would be a tremendous step toward rectifying these problems.

The opinions expressed in this letter are my own and not those of Fulbright & Jaworski or its clients. I appreciate your consideration of my concerns. If you should have any questions or need additional information or assistance from me, please do not hesitate to contact me.

Sincerely,



William Greendyke

WRG/skt

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Please Respond to Boston

Corporate Governance
Internal Assessments
Crisis Management
Regulatory Compliance
Governmental Inquiries
Fiduciary Responsibilities
Education and Training

February 8, 2005

Senator John Cornyn
517 Hart Senate Office Building
Washington, DC 20510

RE: Bankruptcy Venue Reform

Dear Senator:

I commend efforts, either through an amendment to the bankruptcy bill before Congress or through the separate vehicle being introduced by Senator Cornyn, to close a major jurisdictional loophole in the bankruptcy statutes which directly affects every investor, business competitor, creditor, consumer, union, and state Attorney General in this country. While forum shopping and court competition are having a direct, adverse effect on the governance and reorganization of large, public companies, investors are feeling that effect in their returns; employees and unions in the abrogation of collectively bargained contracts and economic security; competitors in the loss of a level playing field; consumers and creditors in the loss of basic rights; and Attorneys General in the loss of power to be heard and to protect the rights of constituents and state public policy.

For the past decade, most bankrupt large public companies have "forum shopped" their cases to the bankruptcy courts in Wilmington, Delaware and New York City. For a time, that was generally thought to be advantageous. But events in Enron and other cases have shown otherwise. The shopping benefited bankruptcy professionals who worked in those cases by enabling them to charge higher fees and by freeing them from some restrictions on conflicts of interest. The shopping also benefited executives of some of those companies by allowing them to hang onto their jobs longer and in some cases even be paid large "retention bonuses."

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Senator John Cornyn
February 8, 2005
Page 2

But the effect of forum shopping on the companies – and hence on the shareholders and bondholders who invested in them – has been decidedly negative. According to major studies and the empirical research of experts like Professor Lynn LoPucki of UCLA law school, companies reorganized in the Delaware and New York courts in the early and mid-1990s failed at a rate more than double the rate for companies reorganized in other courts. As other courts copied Delaware in an effort to staunch their outflow of cases, the failure rates for those courts' reorganizations skyrocketed to match Delaware's rates. To confirm a plan, the Bankruptcy Code requires that the court find that "confirmation . . . is not likely to be followed by the liquidation, or the need for further financial reorganization of the debtor." But of the 43 largest public companies reorganized in U.S. Bankruptcy Courts from 1997 through 2000 – the most recent period for which failure rates can be calculated – 21 (49%) were back in bankruptcy within five years. Historically, the failure rates for big reorganization in non-competing courts have been below 10%.

Legislative action can address this problem in a common sense, fair, simple and direct way, by requiring bankrupt companies file in their local bankruptcy courts. By local courts, I mean the courts in the cities where the companies have their headquarters or their principal operations. This will free judges from the pressures to compete with other courts for cases, and enable them to return to the crucial function for which they were appointed: to protect shareholders, creditors, employees, suppliers, customers and the companies themselves during the brief but often frantic period between the failure of one corporate regime and its replacement with another. It will also ensure that these judges and courts hear from everyone affected and entitled to be heard – not only those who can afford to travel or appear in 'foreign" courts, especially the public's lawyers, the Attorneys General. It is not a panacea for economic insecurity, and it changes no legal rights or duties or law. But it will cure a major inequity and a loophole utilized primarily to "game" the system. Enactment of this bill, or a similar legislative amendment, will enable us to say: "We had a problem, and now we have fixed it."

Scott Harshbarger, Massachusetts Attorney General, 1991-1999

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from the office of

Senator Edward M. Kennedy

of Massachusetts

FOR IMMEDIATE RELEASE
February 10, 2005

CONTACT: Laura Capps/ Melissa Wagoner
(202) 224-2633

STATEMENT OF SENATOR EDWARD M. KENNEDY AT THE HEARING ON "THE BANKRUPTCY PROTECTION AND CONSUMER PROTECTION ACT OF 2005."

Supporters of the legislation we are considering today claim that the issue is curbing reckless spendthrifts who evade their financial responsibilities. Nothing could be farther from the truth.

The Orwellian title of this legislation is "The Bankruptcy Abuse Prevention and Consumer Protection Act." It should be called the Bankruptcy Abuse Promotion and Consumer Punishment Act. If it's enacted, millions of hard-working, hard-pressed Americans will face even greater hardships, so that credit card companies and banks can record even greater profits.

Nowhere is the unfairness of this legislation more evident than in the way it slams the door on bankruptcy relief for people who have the misfortune to be ill. One of the serious costs of the national failure to guarantee affordable health care for every citizen is that illness is bankrupting millions of Americans who've done everything right. They've worked hard, played by the rules, earned a good salary, saved their money, even purchased health insurance – only to find it's not enough when serious illness strikes.

They're already paralyzed heavily by our broken health care system, and this bill punishes them again under bankruptcy law. The profits of credit card companies and banks should not be placed ahead of the needs of hard-working, hard-pressed Americans.

A recent study by Professor Elizabeth Warren and her associates at Harvard exposes the rationale for this special-interest giveaway. Almost half of all Americans who file for bankruptcy every year are the victims of illness. They're not spendthrifts. They did not run up credit card debts on plasma televisions, expensive clothes, or trips to the Caribbean. They're middle class Americans who have had the misfortune to get sick.

Most of these Americans did not seek relief in the bankruptcy courts willingly. In the years before they actually declared bankruptcy, they made extensive sacrifices, struggling to pay

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for their health care and make other ends meet. One in five cut back on food. A third had their electricity shut off. Half lost their phone service. Many more went without needed medical care.

It's indefensible to deny them bankruptcy protection. It is reprehensible to put the interests of credit card companies and banks with great wealth and power ahead of the interests of working families in desperate straits. It is unconscionable to punish people because they have the misfortune to be sick.

As this bill moves forward, we must amend it to protect families with high medical costs from its harsh provisions. The issue is not financial responsibility. These families have more than met that test. The issue is moral responsibility. Will the United States Senate take the responsible course and stand up to the powerful special interests demanding an even larger pound of flesh from the victims of our broken health care system? For those who have had the misfortune to be bankrupted by illness, we owe them the chance to start over. That's been the hallmark of our bankruptcy laws for more than a century and it's wrong for Congress to deny them that opportunity.

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Medical Bankruptcy – Fact Sheet

- 1.458 million individuals or couples filed for bankruptcy in 2001. These bankruptcies involved 1.925 million debtors and 1.939 million dependents- a total of 3.864 million people.

- Between 46.2% and 54.5% of all bankruptcies (midpoint estimate 50.35%) were caused, at least in part, by illness or medical debts. Thus, medical bankruptcy involved between 1,850,098 and 2,227,000 Americans in 2001 (midpoint estimate = 2,038,549).

- The number of medical bankruptcies increased approximately 2200% between 1981 and 2001.

- Most medical debtors had some health insurance, but many suffered gaps in coverage:

  - 75.7% had health insurance at the onset of the bankrupting illness.
  - 68% had coverage at the time of their bankruptcy filing
  - 62% had continuous coverage
  - 1/3 of those with private coverage at onset lost it during the course of illness
  - Only 2.9% of the uninsured went without coverage voluntarily – most others couldn't afford it

- High medical bills contributed to 60% of medical bankruptcies, with drug costs contributing to 48%. (Drug costs were the major problem for most Medicare-insured debtors, and many of those with psychiatric disorders). In 35% of cases lost income due to illness was a factor.

- Out-of-pocket medical costs since the onset of illness averaged $11,854

  - The privately-insured had the highest costs - $13,460 – due to the very high costs incurred by those who initially had private coverage but then lost it.

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- ❖ Cancer patients' costs averaged $35,878.

- Families in medical bankruptcy suffered many privations. In the 2 years before filing for bankruptcy:

  - ❖ 22% went without food
  - ❖ 30% had a utility shut off
  - ❖ 61% went without needed medical care
  - ❖ 50% failed to fill a doctor's prescription

-30-

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Opening Statement of Senator Patrick Leahy,
Ranking Member, Senate Judiciary Committee
Hearing on Bankruptcy Reform
February 10, 2005

I am pleased that the Committee is holding this hearing on bankruptcy reform – the first in four years.

Our nation wears a different face today than it did that last time we held a hearing on bankruptcy reform four years ago. We endured the terrorist attacks of September 11, 2001, which only deepened the financial woes of an already struggling economy.

We have been witness to a parade of financial misdeeds by major U.S. corporations. The names Enron, WorldCom, among others, have left a bitter taste in the mouths of average Americans, damaging investor confidence and shaking our capital markets. Financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk.

Since we last held a hearing on bankruptcy reform, 782,000 private-sector jobs have been lost. Unfortunately, far too many Americans who are working are barely making ends meet – even when holding down two or three different jobs at the same time.

And we are immersed in wars in Afghanistan and Iraq, with no exit in sight.

We must discuss bankruptcy reform in the context of these real-life developments since 2001. In order for bankruptcy reform legislation to be appropriate and fair, its key provisions must be carefully examined and updated where necessary.

This week Majority Leader Frist said the following about bankruptcy reform legislation: "It has been several Congresses since people have really looked at the bill very carefully. So we felt it was important to have hearings as well as to have the opportunity to mark it up, modernize it, before taking it to the floor."

I agree with Majority Leader Frist. We should modernize this legislation to take into account the changes that have occurred in our economy since 2001.

For example, we should strengthen the financial safety nets for middle class American families confronting illness or injury. Medical problems contribute to about half of all bankruptcies, even though most of those who file had health insurance when they first became sick. Many lose their

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jobs – and their insurance – because their conditions worsen, while others face thousands of dollars in co-payments and deductibles and for services not covered by their insurance.

Today we will hear from Professor Elizabeth Warren of Harvard Law School on this matter. I am pleased that Professor Warren could join us to discuss her recent research and analysis of illness and injury as they contribute to bankruptcy.

We should also provide for more disclosure of information so that consumers may better manage their debts and avoid bankruptcy altogether. U.S. consumer debt has reached staggering levels after more than doubling over the past 10 years. According to the most recent figures from the Federal Reserve Board, consumer debt hit $1.98 trillion in October 2003, up from $1.5 trillion three years ago. The total credit card debt alone stands at $735 billion, with the household card debt of those who carry balances estimated to average $12,000.

I know that Senator Grassley, Senator Durbin, Senator Schumer and others share a commitment to include credit industry reforms in a fair and balanced bankruptcy bill. The millions of credit card solicitations made to American consumers over the past years have contributed to the rise in consumer debt and bankruptcies. It is relatively easy to obtain credit, but not nearly enough is done to ensure that credit is properly managed. Additional disclosure is needed to ensure that consumers completely understand the implications of their credit card use.

We must also be careful that our efforts to ensure accountability in the bankruptcy process do not inadvertently create problems for privacy and security. We are in an age where personal information can be easily digitized and shared, and when it falls into the wrong hands, easily abused. Identity theft is one danger, as is tracking and harassing a battered spouse. We should consider ways to minimize these possibilities while we seek accountability.

The economic hardships faced by service members' families are other developing matters that warrant our attention. Calls to serve their country in Iraq, Afghanistan or elsewhere can cause loss of family income, the closing of a family business or additional expenses. Unfortunately, it is not uncommon for service members and their families to be forced into filing for bankruptcy relief. Senators Durbin, Graham and others have taken an interest in this issue, and I look forward to working with them on how we can remedy the situation faced by the brave men and women who serve our nation and their families.

While many things have changed since our last bankruptcy hearing four years ago, there remains one thing that has not changed: The campaign of violence, vandalism and intimidation continues to curtail the availability of family services and endanger providers and patients, and the perpetrators of such violence continue to escape judgment through bankruptcy abuse.

Since the last time this Committee closely examined bankruptcy reform legislation, there have been reported a total 1,245 acts or threats of violence against clinics, providers and patients, including one bombing, eight arson cases, 26 death threats, 577 anthrax threats, 10 assault and

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batteries, 17 burglaries and 26 stalking cases.

For example, in 2002 six defendants in the "Nuremberg Files" web site case have filed for bankruptcy. Five filed for bankruptcy in the days or even hours immediately before scheduled depositions in which they would have had to reveal information regarding their assets. The other defendant filed just before garnishment could be executed.

Senators Schumer and Hatch worked diligently during the 107th Congress to include carefully crafted bipartisan language in the bankruptcy legislation to ensure that perpetrators of clinic violence can not declare bankruptcy in order to avoid paying fines and debts associated with their illegal acts. We then reached a compromise with Congressman Henry Hyde and House Judiciary Chairman James Sensenbrenner, and we included the provision in the final conference report.

The 501-page bankruptcy reform bill introduced a few days ago has been stripped of the consensus clinic violence language and fails to address the discharge of penalties for violence against family planning clinics. As a result, perpetrators of clinic violence can continue to seek shelter in the nation=s bankruptcy courts. That is simply wrong.

Today, Maria Vullo, a top-rate attorney, will testify about the need to amend the Bankruptcy Code to stop wasteful litigation and end abusive bankruptcy filings used to avoid the legal consequences of violence, vandalism and harassment to deny access to legal health services. Ms. Vullo, welcome.

As we move forward with reforms that are appropriate to eliminate abuses in the system, we need to remember the people who use the system, both the debtor and the creditor. We need to balance the interests of creditors with those of middle class Americans who need the opportunity to resolve overwhelming financial burdens. As recent Congresses proved, there are many competing interests in the bankruptcy reform debate that make it difficult to enact a balanced and bipartisan bill into law.

I look forward to working with Chairman Specter on a schedule that would allow our Committee likewise to do its work and serve the Senate by fully and fairly considering legislation on bankruptcy-related issues. These are important subjects that can have a real impact on the lives of many people who have already suffered from illnesses or divorce or job loss. We ought to utilize the expertise of the Members of our Committee to ensure that what we report to the Senate is fair and balanced and that it will not exact an unintended toll on our neighbors.

We need to work in a bipartisan fashion from the beginning to the end of the legislative process to enact reforms that ensure our bankruptcy laws better serve their intended goals.

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January 31, 2005

Senator John Cornyn
517 Hart Senate Office Bldg.
Washington, DC 20510

Dear Senator Cornyn:

I write to thank you for your courage in proposing the Fairness in Bankruptcy Litigation Act of 2005. This legislation will not only provide protection for all parties to large, public company bankruptcies, it will also protect honest bankruptcy judges from the pressures arising from the necessity to compete for cases. My research suggests that by ending the necessity for the courts to compete for cases, this legislation will result in better reorganizations, the preservation of jobs, and higher returns to creditors and shareholders.

This is a difficult issue to present to the public, because it is both obscure and complex. Please be assured that I and many others appalled by the competition will do whatever we can to assist you.

Yours truly,

Lynn M. LoPucki

Prepared Statement of
David McCall, Director, USWA District 1
United Steelworkers of America, AFL-CIO.CLC

to the

United States Senate
Committee on the Judiciary

Hearing on S. 256

Thursday, February 10, 2005

Mr. Chairman and distinguished Senators, I am David McCall of the United Steelworkers of America. I welcome the opportunity to comment on S. 256.

I am the District Director for the state of Ohio, a state that has lost over 200,000 jobs in the last five years, and where our Union and the workers and retirees we represent have experienced bankruptcies at such companies as LTV Steel, Ormet Aluminum, Warren Consolidated Industries, Republic Engineered Products, and Wheeling-Pittsburgh Steel, among the largest. Beyond Ohio, our Union of over 1,000,000 active and retired Steelworkers has experienced bankruptcies at Bethlehem Steel, National Steel, Kaiser Aluminum, and other companies. Given the importance of bankruptcy law to the lives of workers and retirees, you can be sure that our International President, Leo Gerard, would have been here today but for his being out of the country. On his and my behalf and that of our Union, we thank you for holding this hearing and considering the perspectives we offer.

By itself, bankruptcy law cannot solve the many problems facing the American worker and pensioner today. It can't roll back a flood of imports that may undermine a plant or industry, and it cannot directly challenge the transfer of manufacturing jobs to other countries. Nor can it necessarily close the widening gap between rich and not-so-rich in our country, or greatly solve the problems in our health care and pension systems. When these other forces do drive companies under, however, our bankruptcy law should treat workers and retirees as fairly and humanely as possible.

Most of the bill now before this Committee -- S. 256 -- addresses consumer bankruptcies of course. Over the life of this bill and its predecessors, our Union and the rest of the AFL-CIO have viewed S. 256 generally as rendering wholesale changes in the consumer bankruptcy system that would shift the rules decidedly in favor of creditors and to the detriment of individuals. While we believe the bill would make it far more difficult for individuals and families to make fresh starts, and believe that it would do so because of perceived abuses which studies show are not the norm in the system, I know that other members of this panel will be addressing these points.

Let me offer you four points based on the experience of our Union with manufacturing companies in bankruptcy. And much of this experience came well after S. 256 was first conceived and drafted.

First, it would be hard to say what has been worst about the recent wave of bankruptcies in manufacturing – the loss of jobs, the hollowing out of American towns and cities, the shock to families, or the loss of hard-earned benefits. But surely one of the most tragic injuries we have seen is when retirees lose, through bankruptcy, their health insurance, just at the time in life when they need it most, and this has happened to over 250,000 retirees in our Union alone. These are individuals and spouses who spent a lifetime living with hard and dangerous jobs to earn what was supposed to be the peace of mind that comes from employer-paid retiree insurance, only to lose all that as a result of bankruptcy. As you know, retiree health benefits are typically neither funded nor guaranteed by a government agency. If the bankruptcy law is to be seen as legitimate and credible, it must be as humane and fair as possible on this subject, and, while Congress has at least enacted Section 1114 of the Bankruptcy Code, that provision still has weaknesses,

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and I mean even beyond the fact it ultimately allows a judge to cut off all retiree health programs when "necessary for reorganization." Courts often cut the coverage off with exceedingly short notice, and some employers have sought to exploit provisions in both collectively bargained and non-union retiree insurance programs to terminate retiree benefits unilaterally and in defiance of the substantive and procedural protections of Section 1114. Another weakness of Section 1114 arises when a bankrupt company sells its assets to a buyer who absolutely refuses to fund or support any of the terminated health coverage whatsoever. I know Senators Leahy and Durbin and Rockefeller each have developed ideas that would dedicate a greater share of the bankruptcy estate to the vital needs of retirees who lost health coverage in the bankruptcy. In this connection, our Union has been able to bargain with some buyers for even better treatment than those proposals would allow, but the basic point is that the bankruptcy laws should set a better floor of protection below which no retiree can fall.

Second, pensions. Even with a comprehensive federal pension law and the operation of the Pension Benefit Guaranty Corporation with respect to defined benefit plans, too many victims of bankruptcies, especially those in manufacturing, are experiencing the shock and nightmare of losing even pension benefits because of the termination of their plans in bankruptcy and limitations in the amounts of federally guaranteed benefits. We recognize that this is the subject of a recent and comprehensive proposal from the Administration. One of our concerns will be to urge Congress to avoid taking steps that may be intended to encourage good pension funding but could unfortunately have the effect of actually forcing weak companies with underfunded plans to terminate them and simply add to the difficulties of both retirees and the PBGC.

Third, the bill before you proposes to raise the priority for wages from its application to wages and other items earned in the 90 days before filing up to a maximum of $4,925 to a new rule that would give priority to those items earned in the 180 days prior to filing up to a maximum of $10,000. This is progress, but it is not a complete solution. For example, courts in most areas of the country view severance pay -- a critical benefit for a worker who is losing his or her job -- as being earned over such a long time (often an entire working career) that even a rule prioritizing 180 days worth of accrual brings very little severance pay into the priority category. In short, there were two problems with the wage priority provision, both amount and accrual period, and this bill addresses only the amount problem.

Fourth, a section of this bill which does not appear until page 495 of a 501 page document, is entitled, "Preventing Corporate Bankruptcy Abuse." I believe a more comprehensive approach to the problem of corporate abuses would at least have to grapple with two other problems. First, so-called "key employee retention plans" or the notorious "KERPs." These are "golden parachutes" payable to the executives of a reorganizing company and rewarding them handsomely often after they have cut workers' pay, reduced or eliminated retiree benefits, shuttered plants, and sold them off. A second area of concern is the perennial problem of enormous sums of money going to bankruptcy professionals. Congress should look to a reasonable way of regulating these excesses. When workers learn of a KERP or a massive fee award, it puts our bankruptcy system in a bad light and often makes the difficult bargaining choices required in bankruptcy even harder to achieve.

Finally, let me conclude by making clear that our Union commits to working with this Committee and any of its members in your attempts to craft amendments that will help the bankruptcy courts take greater and fairer account of the interests of the workers and retirees of bankrupt companies. Thank you.

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February 9, 2005

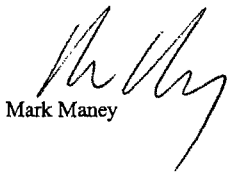
The Honorable John Cornyn
United States Senate
617 Senate Hart Office Building
Washington, DC 20515

Re: Bankruptcy Venue Reform

Dear Senator Cornyn:

Our firm has had the privilege of representing the Official Employment-Related Issues Committee in the Enron Bankruptcies. The unusual appointment of such a committee was necessitated, at least in part, by the fact that Enron filed bankruptcy in New York, rather than in Houston, where the vast majority of its employees resided. The Employee Committee was tasked with representing the interests of former and current employees and with disseminating information to those employees, who otherwise would have found it prohibitively expensive to have their substantial rights addressed. The Employee Committee has fulfilled those tasks, but such an appointment is rare. In nearly all bankruptcy filings, the employees do not have representation appointed by the United States Trustee and must represent their own individual interests. When the corporate employer files for bankruptcy in a distant forum, those employees can be left with no practical remedies for the loss of their livelihoods. We therefore support your efforts in eliminating loopholes in the bankruptcy venue provisions, so that small creditors, and particularly employees, receive the Due Process they deserve.

Very truly yours,



Mark Maney

Testimony of

R. MICHAEL MENZIES

President and CEO
Easton Bank and Trust Company
Easton, Maryland

on behalf of

THE INDEPENDENT COMMUNITY BANKERS OF AMERICA
Washington, DC

on

"Bankruptcy Reform"

Judiciary Committee
of the
United States Senate

February 10, 2005

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Mr. Chairman, Members of the Committee, my name is Mike Menzies, and I am pleased to testify before you today on behalf of the Independent Community Bankers of America (ICBA)[1] and its nearly 5,000 members, representing more than 17,000 locations nationwide. ICBA members hold more than $631 billion in insured deposits, $778 billion in assets and more than $493 billion in loans to consumers, small businesses and the agricultural community. I am President and CEO of Easton Bank and Trust Company, a $100 million bank in Easton, Maryland. I am chairman of ICBA's Policy Development Committee, and serve on the boards of ICBA's Mortgage Corporation and Services Network.

The Portfolio Underwriting Process

Before sharing thoughts about the environment of personal bankruptcy and its impact on our communities, allow me to offer a brief illustration of the loan risk taking process. Community banks are in the risk-taking business. They take risk whenever they make a loan to an individual. In return for that risk, the bank seeks to make a reasonable profit. The customer benefits through the enhancement of his or her financial health. The healthier the customer, the healthier the community, the healthier the bank, the healthier our overall economy and tax base. The underwriting of consumer loan risks is a fundamental driver to all local economies.

Successful consumer lending depends on the numbers. Banks must make many loans to as many people as possible to diversify exposure and spread the risk. In some respects it is almost like health insurance risk taking without all of the health insurance impediments. Consumer lending is a risk sharing business. Many small loans are made so profits from any one loan are small and profit is generated from volume. At the same time losses can be significant relative to unit profitability. This is especially true when the entire principal of a loan is lost all at once. Let me review the consumer loan portfolio example attached to my testimony[2]:

The example consists of two simple revolving loan portfolios, each containing 100 loans of $1000 apiece, and each paid off within a year. One portfolio has an interest rate of five percent, the other a rate of 18 percent.

If one loan in the five percent portfolio were to immediately default (regardless of causation), it would take the interest payments from 41 performing loans to compensate for that default. Lets put it another way. If you are earning 5 percent on a loan and you lose 100 percent of the principle, you have lost 20 times the interest you were earning. It would take 20 years from another loan of the same size and rate just to make up for the loss. If as few as three borrowers default, the lender has a completely unprofitable portfolio.

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[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

[2] The two examples are simplified just to show how the numbers move around in a default situation—a real life portfolio is much more complicated and would account for such items as loan loss reserves and tax write-offs, which assuming you are profitable, do mitigate some of the losses. As you can see however, it is very easy to become unprofitable in the lending business.

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If one loan in the 18 percent portfolio defaults, it takes the interest from 12 performing loans to compensate for that one default. Obviously, if a lender is experiencing greater losses than anticipated, they have to either charge more or make fewer loans because of diminished capacity.

There is not much more to underwriting than that, but it is very difficult and lenders expend a tremendous amount of effort to try and get it right. A lender that provides the greatest number of borrowers with the best rate while keeping defaults to a minimum is going to have both the most profits and the most customers. Anything that enhances this process has obvious consumer benefits. Anything that detracts has obvious downsides—again we either have to raise prices or reduce lending.

Bankruptcy Policy and the Underwriting Process

Essentially, it seems to me that when we are talking about bankruptcy law, we are making policy interventions that determine how the costs of default are socialized across all borrowers through those that either loan money in return for future payment, or who render services in exchange for future payment. The ICBA supports the availability of bankruptcy for those that truly need it. These individuals should get in and out of the system as quickly as possible and the system should focus its resources on those filers that have the capacity to repay a meaningful—not just a few dollars—amount of debt. As you saw in the example I just discussed, it takes very few bankruptcies to greatly increase costs, and if we can reduce these by even a few, or increase recoveries in a meaningful way, it greatly reduces the costs that are socialized among other borrowers. The ICBA feels that S.256 greatly improves the balance in this area, and does so in a way that is not unfairly burdensome to those seeking relief.

As a community banker, we see bankruptcy close up and understand that causes of bankruptcy are complex. The industry has long understood, and since 1997, testified before both the House and Senate that many factors such as divorce, lack of health insurance etc. all play a role in causing bankruptcy. [3] We cannot and would not underwrite for these types of factors—can you imagine if on the credit application, we asked about such matters? We confine our underwriting to ability to repay and feel that the same neutral approach to whether a debtor receives a complete discharge or has to repay some portion of their indebtedness is the only workable approach. The means test in S.256 seems to us to provide a reasonable approach towards making sure that those who can pay a meaningful amount do so while providing a full range of safeguards for debtors who cannot. Looking back at our underwriting examples, any other approach simply results in an unfair distribution of costs among those who are paying their bills—the vast majority of my customers.

The ICBA would also like to take this opportunity to express support for other provisions of the bill that restore balance and responsibility to the bankruptcy system overall, notably the provisions that ensure payment of domestic support obligations. While this obviously does not benefit us directly in dollars and cents terms, we believe that a society that places a priority on ensuring these obligations are met creates a better climate for both lenders and consumers and in the long term results in a fairer socialization of costs.

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[3] Attached is a copy of testimony given in 1998 by Stuart M. Feldstein of SMR Research before the House Committee on the Judiciary that provides an excellent discussion of the causes of bankruptcy.

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Conclusion

The ICBA believes bankruptcy is an appropriate solution for individuals who have legitimate reasons to walk away from their obligations. ICBA recognizes that all other borrowers pay for the losses created by those who are discharged from their debts. This tax on the majority of individual borrowers should be mitigated wherever possible. Healthy consumer borrowers benefit communities, their economies and our overall tax base. Economic disincentives such as unnecessary bankruptcies or discharge of debts hinder the wealth formation process that is necessary for social progress.

Unbalanced bankruptcy policies have significant social implications, whether manifested in the casual avoidance of domestic support obligations, state taxes or debts owed to lenders. A balanced policy will recognize that there are situations where it is appropriate to relieve individuals of all or part of their financial responsibilities, but at the same time will encourage Americans to take ownership of their financial health, which is of course intertwined with physical, spiritual and personal health.

The ICBA would like to again express its strong support for S. 256 and appreciates the efforts of the Committee to provide a modern legal framework for bankruptcy. We hope that after eight years of extensive consideration, the Committee will move expeditiously to enact this much needed legislation, and on behalf of community bankers, we stand ready to do everything possible to assist the committee in its efforts.

Attachments

Attachment 1

$1000 loans made to 100 borrowers (principal = $100,000) to be paid in one year (no compounding, regular monthly payments)

	Scenario 1	Scenario 2
Interest rate	5%	18%
Value of each loan (paid in one year; paid regularly over the year)	≈ $1,025.00	≈ $1,090.00
Effective rate of return	≈ 2.5%	≈ 9.0%
Value of the portfolio	$102,500.00	$109,000.00
The non-performance of one of the 100 loans = the interest payments of	41 borrowers	12.11 borrowers
To earn expected profit (in $) at given interest rate on the assumption that one borrowers will default at the outset, loans must be made to	141 borrowers (=starting principal of $141,000.00)	112.11 borrowers (=starting principal of $112,111.11)
Effective rate of return (with one expected default and new borrowers/added principal to compensate)	1.77%	8.03%

At lower interest rates, the rate of return on each loan requires more borrowers to make up for each non-performer than do loans with higher interest rates. In Scenario 1, 40 borrowers are needed to safeguard the principal extended to one borrower. In Scenario 2, only 11 borrowers are needed to do so.

Attachment 2

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The Rise in Personal Bankruptcy:

Causes and Impact

Stuart A. Feldstein

President

SMR Research Corp.

300 Valentine Street

Hackettstown, NJ 07840

(908) 852-7677

Presentation to the Subcommittee on Commercial

And Administrative Law

U.S. House of Representatives, 3/10/98

Introduction

Personal bankruptcies exceeded 1.3 million in 1997 -- a new record by far. The 1997 filings were up more than 200,000 from 1.1 million in 1996, which also had set a record. These recent annual increases alone are larger than the total number of bankruptcies was in the early 1980s. In 1998,

the number of personal bankruptcy filings is highly likely to be double the level of just four years earlier; there were 773,117 filings in 1994.

Clearly, we are in the midst of a wild and unprecedented escalation in personal bankruptcies. Bankruptcy filings per capita have been rising each year since 1985, except for two years (1993 and 1994). Since 1995, the pace of the increase has become explosive -- surprisingly, since the national economy is in such good shape.

Unemployment is very low and jobs are growing fast. Inflation-adjusted personal incomes are rising, homes are selling in record numbers, inflation seems under control, consumer confidence is high, and banks' commercial loans are showing extremely low loss rates. How could it be that in the middle of such prosperity, we could have two consecutive years of record-setting personal bankruptcies, almost surely to be followed by another record in 1998?

We believe there are multiple reasons for this. They make the problem more complex than some observers think when they lay the blame on just one causative factor or another. Our research shows that the causes of the bankruptcy increase can be put into three groups:

First, there has been an increase in the frequency and the cost of certain financially disastrous events that happen to people. These events can happen solely due to bad luck, or they can be the direct result of an individual's behavior. Among these problems are divorce, lack of health insurance, the rampant spread of casino gambling, driving without auto insurance, and an increase in entrepreneurial self-employment.

Second, there are three problems related to consumer debt: 1) Actual debt owed by people has grown, 2) There has been even faster growth in the amount of unused but available consumer credit lines, and 3) Since the early 1980s, consumers have amassed a great deal of adjustable rate debt,

meaning that interest rate movements now change monthly loan payments.

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Third, we believe there are non-financial issues behind the bankruptcy increase, including greatly increased lawyer advertising and a reduction in the social stigma once associated with bankruptcy. Only these intangibles seem available to explain why bankruptcy is growing even faster than all the other reasons previously described.

This paper also deals with what we believe to be some common misperceptions about why bankruptcies have increased. Finally, it touches on the impact of rising bankruptcies on solvent consumers and on financial institutions.

The Rise in Economic Disasters

In 1986, SMR first postulated the theory that bankruptcies were increasing, at least in part, because of an increase in the frequency or severity of so-called "insolvency events." These are financial disasters that cause family debts to spike suddenly, destroy savings, or otherwise change the monthly income to debt ratio.

We developed this theory by looking at our state and local area bankruptcy filing rates per capita and then searching for correlating data sets that would explain why some places are so very much better or worse than others in filing rates. Since 1989, SMR has been collecting data on the numbers of bankruptcies filed in each U.S. county, metro area, state, and nationally, and we divide these numbers by population for a per capita bankruptcy filing rate, allowing all places to be compared fairly.

One problem is divorce. Although the annual rate of divorce is now a bit lower than at its peak in the 1980s, there has been a steady, inexorable increase in the percentage of adults who, at any moment in time, happen to be divorced. Census data show that in 1965, only 2.9% of American

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adults were divorced, and this number has now ballooned to about 10% of all adults 18 and older. Because the annual rate of marriage is only about twice as high as the annual rate of divorce, the percentage of adults who happen to be divorced is mathematically certain to continue to rise, ultimately to 15% or even 20%, barring some major change in how well people get along.

There are some obvious financial problems that come with divorce. Two people who had one monthly housing bill suddenly have two, and they have legal bills to pay, and possibly new child care costs, plus alimony and child support payments that in some cases puts a financial strain on one spouse or the other. In some cases, the worst thing that can happen is to be awarded the family home and car -- and the monthly payments that go along with them. Divorce does not necessarily cause financial disaster immediately, but can do so years later when savings are finally depleted or mandated alimony or child support payments become too great to bear.

We find that per capita bankruptcy filing rates and divorce rates match well at all geographic levels tested -- even county-by-county across the country. Credit managers are well aware that divorced people in general have greater credit risk than married people, however fair credit laws prohibit the use of marital status as a criterion for granting credit.

Another, and potentially greater, economic disaster strikes when people become seriously ill or injured and either don't have health insurance or else don't have enough of it.

The Census Bureau reports that some 40 million Americans have no health insurance of any kind, including any government program, and this number is at or near a peak for modern times. Even if this number were not at a peak, the rise in the cost of medical services would put uninsured people at greater risk of default than they used to be. Again we find general correlation between state-level bankruptcy rates and percentages of the population lacking health insurance as reported by the Census. Places with very high bankruptcy rates often have high percentages of uninsured people, and places with low bankruptcy rates almost never have large percentages of the population lacking health insurance. Various surveys done over the last two years of bankruptcy filers consistently show that 20% or more of them cite medical debt as a major contributor to their defaults.

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Car insurance is another problem. Using the midpoint of two insurance industry estimates, it appears that some 25 million Americans now drive cars without car insurance. In some states, doing that is within the law, and in most of those states, the bankruptcy rate is very high, including Tennessee and Alabama.

The spread of casino gambling also appears to be a problem. When we look at bankruptcy rates in counties that have major gambling facilities in them, those rates are higher than in counties that have no gambling facilities. According to the American Gaming Association, U.S. households made a record 154 million visits to gambling casinos in 1995 -- an increase of 235% over five years. On the county map in Nevada, the closer you come to Las Vegas and Reno, the higher the bankruptcy rate generally gets. In California, the highest bankruptcy rates typically are in San Bernardino and Riverside counties, which are the closest to Las Vegas, and the fourth highest rate often is in Sacramento County, closest to Reno. In New Jersey, Atlantic County, which is where the casinos are, typically has either the highest bankruptcy rate or one of the two or three highest in the state. In Tennessee, the bankruptcy rate is highest in Shelby County, the heart of Memphis, which is right across the state line from the Tunica MS casino gambling complex, reportedly the largest outside of Nevada.

The AGA has officially expressed disagreement with our view that gambling is a contributor to bankruptcy. We respect their opinion; we were under the impression that in casinos, the odds favor the house and people sometimes lose. As the number of gamblers increases, so would the likelihood that some people lose a lot.

Indeed, with all the risk factors just cited -- lack of health insurance, divorce, driving without insurance, and gambling -- the bankruptcy problem is actuarial. The vast majority of people who gamble will gamble responsibly. Most people without health insurance will be lucky and avoid serious injury or illness. Most divorced people will find a way to handle the financial strain. The problem is that if only 1% of these growing high-risk groups have a problem, they could account for at least 500,000 bankruptcies per year.

Consumer Debt: Problems and Misconceptions

One widely held belief about bankruptcies is that they have increased purely because people have more financial debt than they used to have. And, in some news articles about bankruptcy, the aggressive marketing of credit cards has been blamed as the prime culprit in this debt spiral.

There is certainly some validity to the notion that increased loan debt is related to the increase in personal bankruptcies. However, the relationship between these two events has not been very strong in the 1990s, and we think there are some fundamental misunderstandings about what the connection really is between debt and bankruptcy.

Both consumer debt and bankruptcies have increased in the 1980s and 1990s. But the lion's share of the debt increase hasn't been in credit cards; it's been in housing debt. All one needs to confirm that is a quick glance at the monthly Federal Reserve Bulletin, where the tables regularly break out consumer debt by category.

We can compare the most recent Fed figures for 1997 to the same debt categories 10 years earlier in 1987. (Or, you can compare the current numbers against any other year in recent history and reach the same conclusions.)

In 1987, the total dollars owed on residential mortgage loans were $1.959 trillion, and the total dollars owed on all forms of non-real-estate revolving debt (credit card, unsecured personal lines, and checking account overdraft loans) were $153.9 billion. In 1997, the total dollars owed on residential mortgages were $4.027 trillion, and the total owed on all revolving debt had reached $529.7 billion.

So, over the 10 years, mortgage debt increased by more than $2 trillion and credit card and related debt increased by $375.8 billion. Put another way, the dollar increase in the mortgage category was more than five times the size of the increase in the credit card category.

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Furthermore, even these numbers understate the difference. When the Fed looks at housing debt, it only counts mortgage loans. It does not count the housing payments made by renters as being "debt." And yet, renters must make those payments every month, just as homeowners must pay their mortgage loans, and rents are higher today just as mortgage debt is higher. When you combine residential mortgage debt with a pro-forma debt amount for renters, what you find is that today, total housing debt is around $6.2 trillion -- more than 10 times the size of total credit card debt.

SMR has no hidden agenda in making these observations. We have some clients in the credit card business but a lot more clients in real estate lending who may cringe to see us make these comments. It just happens to be true that most of the consumer debt in this country is housing debt, not credit card debt, and the real estate debt also is what has been increasing most rapidly by far.

This means that it's very hard to be honest and blame the bankruptcy mess on aggressive lender marketing techniques. The increase in housing debt has come as a result of more people buying homes, and the escalating prices of homes. Also, mortgage lenders, for a variety of reasons, now tend to make loans at higher ratios to the values of properties than they used to do. It's not the mortgage lenders stuffing your mailbox with offers to finance your next home purchase; indeed, mortgage lenders cannot make wild offers of credit since they must first do appraisals, title checks, and other lengthy underwriting. The credit card issuers are the ones engaged in heavy marketing, yet we've just seen that their portion of total debt is small and the increase in card debt pales in contrast to housing debt. These facts call into question the notion that hyper-aggressive credit card account marketing is behind the bankruptcy spike.

Moreover, there are reasons to think that although levels of consumer debt are certainly related to bankruptcy, the entire connection is getting a little weak, and something else is also going on.

For example, in 1993 and 1994, total consumer debt continued its normal rate of increase, but bankruptcies declined significantly. From 1995 through 1997, the rise in consumer debt moderated, but the bankruptcy rate exploded. By our estimate, the U.S. consumer debt-to-income

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ratio actually improved in 1997 over 1996, mainly because incomes got better, and this happened just as bankruptcies reached a new record high.

Further, consumer debt to income ratios fail to correlate with bankruptcy rates at the state, MSA, or county levels as shown in our database. The greatest single variable in the consumer debt load from one state or locale to another is the cost of housing; it is the largest piece of debt and annual housing costs can vary by three-fold from one place to another, like California versus Mississippi.

But many places with reasonably low ratios of debt to income also have some of the nation's highest bankruptcy filing rates -- like Tennessee, Alabama, and Mississippi. Other states not so distant from these have low d-t-i ratios and low bankruptcy rates, like North and South Carolina. There are states with high d-t-i ratios and high bankruptcy rates, like California, Oregon, Nevada, and Virginia, and states with high d-t-i ratios and much lower bankruptcy rates, like Delaware, New Hampshire, and Maryland. In short, it's very hard to see any pattern at all in these data.

There are two other aspects of consumer debt that probably do play a role in bankruptcy. One is adjustable rate debt and the other is debt that's unused but available to consumers.

I noted earlier that bankruptcies fell in 1993 and 1994 -- the only two years out of the last 12 when that happened. How come? The only explanation we know of is interest rates and adjustable debt. As recently as 1980, there was literally not a dollar of consumer debt with an adjustable rate. Today, we estimate that more than $1.5 trillion of adjustable rate consumer debt exists, most of it comprised of adjustable rate mortgages. This means that when prevailing interest rates rise, monthly debt payments rise later (often lagging one year) for millions of Americans, and when interest rates fall, monthly payments get easier. In 1993 and 1994, bankruptcies fell after interest rates had declined very significantly, and then rates went back up rather dramatically in later 1994 and in 1995, followed by a bankruptcy surge.

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Finally, there's the matter of available debt. I said earlier that credit cards cannot be blamed for the rise in total consumer debt, but what they have done is dramatically increase the credit lines that are available to people who may get in financial trouble for other reasons.

In mid-1997, we tallied the total extended credit card lines of all U.S. banks at yearend 1996, using bank call and income regulatory reports and other data, and the number was $1.78 trillion. That was nearly double the amount of 1993, just three years earlier.

The $1.78 trillion is not what people owed; it is the amount of their total credit lines on plastic. Americans typically only draw down an average of 20-25% of their available credit card lines. The problem is that if an average consumer does get into financial trouble for any reason, he now has much greater ability to turn to his untapped credit card lines to forestall the day of reckoning. By the time he ends up in bankruptcy court, he can have massively larger unsecured debts than he could have had before, because credit card issuers have been making such large increases in available lines to try to keep their customers happy and avoid losing them to competitors.

So in our opinion, credit card issuers are being unfairly treated by their critics in some regards, while on the other hand most of the critics haven't really noticed what the card issuers actually have done to exacerbate the cost of bankruptcy. We have advised credit card issuers in our research publications to stop using large credit lines as a marketing tactic.

The Intangible Issues: Hard To Measure, But They Exist

The really interesting thing about all the problems I've just described is that they explain some of the bankruptcy mess, but not all of it.

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Personal financial disasters and per capita debt-to-income ratios have worsened gradually. They did not get worse by 29% in 1996 over 1995, but bankruptcies did. They did not worsen again by 20% in 1997 over 1996, but bankruptcies did. So, the hunt for causes of bankruptcy isn't over yet.

The only available conclusion is that certain intangibles are playing a role. One is lawyer advertising. Like adjustable rate debt, you rarely saw any lawyer advertising for bankruptcy prior to about the mid-1980s. In fact, lawyers didn't advertise for much of anything.

Today, lawyer advertising for bankruptcy is prevalent and often provocative. We did a brief study of telephone book ads and found that cities with high bankruptcy filing rates usually do have higher levels of lawyer advertising than cities with low filings rates. A recent look through the Las Vegas Yellow Pages shows more than 100 pages of lawyer advertising, of which roughly one in 10 mentions or is devoted to bankruptcy. Las Vegas has one of the highest urban area bankruptcy rates. We're sure lawyers would argue that they are merely responding to higher demand for their services. But since the whole purpose of advertising in any business is to sell products and services, we would imagine that advertising for bankruptcy gets results, too, and helps convince at least some people to use bankruptcy to eliminate their debts. We have no idea how to measure this precisely.

At the same time, we agree with Fed Chairman Greenspan, who has attributed the bankruptcy increase to a general loss of social stigma once attached to the subject.

We can see in our database a very interesting fact along these lines. Places that used to have very low bankruptcy rates back in 1989, when we started compiling the data, have had a mixed experience since then. Some have stayed low, and some have gotten a little worse, and some have gotten a lot worse. But when we look at places that had very high bankruptcy rates back in 1989, they've virtually all stayed high and never got better. Why would that be?

Certainly, one explanation must be that when bankruptcy filing becomes common in a local area, everyone ends up knowing someone who did it. Bankruptcy becomes de-mystified and begins to

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lose its embarrassment. Indeed, if you know a person who ended up prospering as a result of bankruptcy, then bankruptcy certainly may begin to sound like a smart strategy -- like a mortgage refinance.

At the same time, consumers have watched the stigma of bankruptcy disappear in the business world. The airlines have filed for bankruptcy -- some more than once -- and yet the planes usually keep flying. Retailers have filed, yet the stores stay open. Bankruptcy thus must be something other than financial disaster.

Impact of Personal Bankruptcies

What impact are bankruptcies having on consumers and on the nation's financial institutions? The short answer is that rising bankruptcies are impacting all consumers and some, but not all, lenders.

Many large commercial banks have been reporting record or near-record profits. That is true in part because some banks do more commercial lending than consumer lending, and it's also true because financial institutions pass along the cost of bankruptcy in their rates and fees, as they do with other costs.

The same could be said of non-bank creditors. Any business is a creditor when it provides good or services and waits to be paid for them later on: electric and gas utilities, phone companies, landlords, retail stores with credit cards or other credit plans, doctors, dentists, hospitals, and others. All these businesses extend credit without collateral and lose what they are owed when unsecured debts are expunged in bankruptcy. So, the cost of bankruptcy is included on the expense side of the income statement. Banks put bankruptcy costs in their "provisions for loan losses;" AT&T includes its bankruptcy costs in a line on its income statement called "uncollectible bills." Consumers may or may not be aware of it, but most of what they spend

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every month has a bankruptcy cost factor built into it, from the phone bill to the car payment to the rent and the credit card bill.

Lenders' business can be divided into two basic parts: loans made to individuals and loans made to businesses. Recently, business lending has been very profitable. Loan demand has been strong thanks to the economy and credit quality has been excellent. Oddly enough at a time when consumer bankruptcies are skyrocketing, credit quality on commercial loans is the best we've seen in many years.

As recently as the late 1980s, commercial mortgage loans and loans on apartment buildings had very high delinquency and loss rates, due in part to sloppy lending and due in part to the fact that shopping centers, apartments, and office buildings were overbuilt in the 1980s. Today, when we aggregate the FDIC call and income reports of commercial banks -- and even when we look at the quarterly financial reports of the nation's remaining thrifts -- we see the opposite. Net chargeoffs are now extremely low on commercial mortgages and apartment building mortgages, as well as on non-real-estate commercial and industrial loans made to corporations for miscellaneous purposes. So, one reason behind good bank profits is the extraordinary strength of commercial lending.

When we turn to loans made to individuals, we must subdivide that world into secured and unsecured loans. All of these are indeed being impacted by the personal bankruptcy increase, but the bulk of these loans are in 1-4 unit residential mortgages, which have homes as collateral. Lender losses on mortgages are comprised of chargeoffs when loans go into foreclosure minus recoveries when the foreclosed properties get sold. Here again, the strong economy and the super-powered housing market have helped enormously. In both 1996 and 1997, we saw record numbers of home purchases, plus accelerating average home prices. This has meant that foreclosed homes coming onto the market are selling rapidly and for good prices, enabling mortgage lenders to recover a substantial portion of their charged off loans.

Of course, if the housing market slows, as it eventually must, then we will see more damage to mortgage lenders from bankruptcies. I know that the Mortgage Bankers Association is worried about this.

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Let's move to unsecured lenders. Here, we do see the impact of personal bankruptcies now. Each year, SMR produces a combined income statement for credit card banks, using the FDIC call reports and defining these banks as any banks whose credit card outstandings are more than 50% of their total loans. There are about 60 such banks in the United States, and they represent well over half of all credit card receivables.

From 1994 to 1996, these banks as a group saw their after-tax profits as a percent of average managed assets decline from 2.26% to 1.31%, and the principle reason was the increase in the provision for loan losses, in turn higher due to escalating bankruptcies. When we calculate profitability for card issuers in 1997, in about a month, we strongly believe we'll see the 1.31% margin fall further to just over 1% even. Some credit card banks already have been unable or unwilling to cope, hence we have seen such events as Advanta Corp. recently selling its ailing card business to Fleet, and AT&T selling its card business to Citicorp.

Credit card profitability, although much reduced, is still OK for the time being. The reason for that is simple: Credit card issuers have raised their prices to help compensate for bankruptcies. It's not the interest rates on credit cards that have gone up, but the fees.

About 10 years ago, in 1987 and 1988, our collection of credit card direct mail pieces shows that late payment fees most typically were $5 or $10. In 1996, card issuers really started raising these fees, and they now usually range from $15 to $25. Also back in 1987 and 1988, many issuers charged no fees at all when consumers exceeded their credit line limits, although some charged $5 or $10. Now, over-limit fees also have jumped to the $15 to $25 range.

The fastest-rising cost in credit cards is consumer bankruptcy, so these fee increases are being used to help pay for that cost and keep profits up. These new fees are arguably unfair, since they cannot be assessed on the bankruptcy filers who have caused them, and instead are charged to a class of people who can least afford to pay for them: people who have not filed for bankruptcy but are late payers or are over their credit limits, often due to financial stress. That's unfortunate, but how do you make a price increase fair when you cannot assess it on the customers who cause a cost increase?

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We have tried to estimate the public cost of bankruptcy, although this is not easy to do. The right method would be to have someone follow through to fruition all bankruptcy cases and add up all the amounts of debt ultimately discharged. No one I know has the time or money to do this.

So, we can only use available data to make rough estimates of the cost of bankruptcy. One method is to look at how many good-paying customers creditors need to offset the impact of a single bankruptcy.

For creditors, bankruptcy is a pre-tax expense. Our method is to look at the typical pre-tax profit earned by lenders per household and see how many households are needed to offset the cost of a bankruptcy filing.

As of June, 1997, total outstanding consumer debt was $7.2 trillion, including a pro-forma debt amount for renters. Total outstanding financial debt per U.S. household turns out to be $72,455. In 1996, the most recent full year available, all U.S. banks as a group earned pre-tax profits of 1.74% of their outstanding assets, therefore their earnings per household would be 1.74% of the $72,455, or $1,261.

The average amount discharged in a personal bankruptcy appears to be somewhere around $41,000, by our estimate from data compiled by Visa and the Credit Research Center. So, if you earn $1,261 from good-paying households per year, you divide that into the $41,000 you lose in a bankruptcy and conclude that it takes 33 good-paying households to pay for a single bankruptcy case.

In some ways, this impact is understated. In our compilation of debt, we did include a pro-forma amount for renters, but in fact the lenders don't get that money, landlords do. If you subtract the renter debt, you end out with total U.S. consumer debt of $5.139 trillion, or about $51,390 per U.S. household. Then, the lenders' pre-tax margin of 1.74% yields pre-tax income of $894 per

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household, and suddenly you find it takes 46 good-paying households to make up for one bankruptcy.

The following table shows the more conservative assumption and concludes this paper.

Number of good-paying households it takes to pay for one personal bankruptcy case:

Total consumer financial debt (includes all loan debts and rent, but not medical, utilities, or other debts or monthly expenses)

Source: Federal Reserve Bulletin, 6/97

1-4 unit residential mortgage debt -- $3,912,079,000,000

Pro-forma housing debt of renters -- $2,106,504,000,000[1]

Auto debt -- $ 380,809,000,000

Revolving (card) -- $ 491,813,000,000

Other loans -- $ 354,339,000,000

Total consumer financial/rent debt: $7,245,544,000,000

[1]Pro-forma debt of renters calculated by SMR. Homeowners are 65% of all households and renters are 35% (Census Bureau). Since renters have to pay monthly amounts just like homeowners with mortgages, we have added this pro-forma number based on the 35% of households being renters.

# of households in the United States: 100 million

Financial Debt/Household: $72,455

All banks, pre-tax return on assets in 1996: 1.74%

Financial industry pre-tax profits per household: ($72,455 X 1.74%): $1,261

Average amount discharged in a personal bankruptcy: $41,000

(Staten & Visa data, from samplings)

Number of good, bill-paying households needed to compensate for one

bankruptcy filer ($41,000/$1,261): 33

About SMR Research

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SMR Research Corp. is the nation's largest publisher of market research studies on consumer loan subjects and also produces a variety of statistical research products.

Founded in 1984, SMR publishes annual or semi-annual studies of the residential mortgage, home equity loan, and credit card markets. SMR also produces statistics and studies on consumer credit risk, and these have included three published studies of personal bankruptcy and its causes since 1992. The largest of these studies was published in May of 1997 and was entitled: The Personal Bankruptcy Crisis: 1997. SMR also maintains an extensive bankruptcy filings electronic database, which includes filings and filing rates per capita, for all U.S. counties, states, metropolitan statistical areas, and the nation, updated quarterly and with a history back to 1989.

SMR is an independent firm and funds its own research publications, which are available for purchase to anyone. Clients for SMR published research have included a majority of larger U.S. banks, savings and loans, mortgage companies, life insurance companies, consumer finance companies, and brokerage houses, plus some government agencies, government-sponsored enterprises, oil companies, retailers, and others.

Stuart A. Feldstein is president of SMR. Formerly editor of the Corporate Strategies section of Business Week magazine, Mr. Feldstein has been the senior author or editor of SMR studies since 1984.

George R. Yacik and Leigh A. Smith are vice presidents of SMR. Mr. Yacik, formerly an executive at the American Banker newspaper, helps manage SMR's publishing business. Mr. Smith, formerly a research executive at Barnett Banks, manages SMR's data products business.

SMR is based in Hackettstown, NJ.

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U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

The Honorable Charles E. Grassley
United States Senate
Washington, D.C. 20510

Dear Senator Grassley:

This responds to your letter, dated February 5, 2005, requesting information from the Executive Office for United States Trustees (EOUST) concerning medical debts of those who file for bankruptcy protection and the recently published study in the Health Affairs journal ("Market Watch: Illness and Injury As Contributors to Bankruptcy").

It is the practice of the U.S. Trustee Program (USTP) not to comment on data collected and analyses performed by outside researchers for reasons that include difficulties in verifying their data and research methodologies. It is noted in the cited study of 1,771 filers that very broad definitions of "medical bankruptcies" are used. The authors considered a "Major Medical Bankruptcy" to include cases in which debtor reported any of the following: illness or injury as a reason for filing bankruptcy; uncovered medical bills exceeding $1,000 in the past two years; loss of two weeks of work-related income due to illness or injury; or mortgage of home to pay medical bills. The authors considered "Any Medical Bankruptcy" to include cases containing any of the factors above or birth or death in the debtor's family or addiction or uncontrolled gambling.

Enclosed is a description of related USTP data and a summary of findings from analysis of a similar but larger sample of bankruptcy cases (5,203) utilizing data from official records during approximately the same time period as the study cited above. It should be noted that reported credit card debt also may reflect medical-related debts, but are not shown in these findings.

In general, the data describing medical-related expenses contained in official documents filed by chapter 7 debtors reveal that slightly more than 5 percent of their general unsecured debt is medical-related. The conclusion that almost 50 percent of consumer bankruptcies are "medical related" requires a broad definition and generally is not substantiated by the official documents filed by debtors.

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The Honorable Charles E. Grassley
Page Two

We hope this information is responsive to your inquiry. If we can be of further assistance, please do not hesitate to contact this office.

Sincerely,

William E. Moschella

William E. Moschella
Assistant Attorney General

Enclosure

Summary of USTP Data and Findings on Medical Debt

USTP Data:

The USTP database contains 5,203 no asset chapter 7 cases that were closed between 2000 and 2002. The database includes cases filed in 48 states, Washington D.C. and Puerto Rico proportionate to chapter 7 filings in each location. The database contains no cases from North Carolina and Alabama, because those states are served by Bankruptcy Administrators. Nearly all of these cases had been filed about four months prior to closing.

On each petition we reviewed Schedule F of the petition to see if any medical debts were listed. This would include where the creditor was a doctor, hospital or other treatment facility, medical collection agency, or if the debt was in any way identifiable as being medical in origin.

This accounting would not have identified medical debts charged on credit cards, placed with certain collection agencies, or paid prior to the bankruptcy filings.

Findings:

All Debtors (N = 5,203):

- 54% listed no medical debt.
- Medical debt accounted for 5.5% of the total general unsecured debt.
- 90.1% reported medical debts less than $5,000.
- 1% of cases accounted for 36.5% of the medical debt
- Less than 10% of all cases represent 80% of all reported medical debt.

Cases Reporting Medical Debts (N = 2,391):

- Among the debtors reporting medical debt, the average medical debt was $4,978 per case.
- 78.4% reported medical debts below $5,000 (average of $ 1,212 for this group).
- 21.6% reported 80.9% of the total medical debt.
- Medical debts accounted for 13.0% of the total general unsecured debt for those reporting medical debt.

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February 7, 2005

Honorable John Cornyn
United States Senate
517 Hart Senate Office Bldg.
Washington, DC 20510

Re: Amendment to Section 1408 of Title 28, United States Code

Dear Senator Cornyn:

As a bankruptcy practitioner for some twenty-five years, I am writing to voice my support for an amendment to the venue provisions of Section 1408 of Title 28, United States Code. As has been well documented, the concept of "forum shopping" by significant Chapter 11 Debtors throughout the country has become an art form over the last few years. Certain jurisdictions now actively campaign to attract large, high-profile bankruptcy cases to their venue. It goes without saying that bankruptcy judges must become "Debtor friendly" in order to maintain the attractiveness of these venue options. Accordingly, decisions relating to the allowance of professional fees, conflicts and other critical bankruptcy issues have become disparate throughout the country.

An amendment to Section 1408, which limits the use of the state of incorporation to those instances where the Debtors' principal place of business or principal assets reside, will promote uniformity as well as removing some of the perceived inequities in the system. The public's perception of a fair and uniform bankruptcy system is paramount.

Thank you for your interest in this legislation.

Very truly yours,

Russell L. Munsch

RLM:akb

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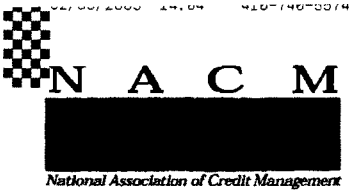

January 31, 2005

Senator John Cornyn
Room 517
Senate Hart Office Building
Washington, DC 20510

Dear Senator Cornyn,

On behalf of the National Association of Credit Management (NACM), I am writing to express the support of NACM National Board of Directors and the NACM membership for the Venue in Bankruptcy Cases bill scheduled to be introduced by Senator Cornyn. This important legislation would provide enormous relief to the thousands of business creditors, and most importantly to small business creditors whose interests are routinely impaired by a bankruptcy process that is long-overdue for change.

NACM is a 22,000-member trade association, representing the interests of corporate (commercial) credit executives. NACM was founded in 1896 and represents both American business credit professionals in all 50 states as well as business credit executives in more than 30 countries worldwide. NACM's mission is to ensure the constant improvement and enhancement of the business trade credit profession and process.

NACM's membership comprises all types of businesses: manufacturers, wholesalers, service industries, and financial institutions. NACM's members range in size from small businesses to a majority of the Fortune 500. NACM members make the daily decisions to extend unsecured, business and trade credit from one company to another. NACM members – the business credit executive – approve and provide billions of dollars each day in business and trade credit, which fuels this country's business economy.

This bill would provide much needed relief to businesses and – perhaps even more importantly – to small businesses. This bill would provide relief to the current practice of requesting a transfer of venue, which is both expensive and time consuming to both the debtor's estate and to creditors. Additionally, this bill would address any abuse that currently exists in the Code that encourages "shopping" cases into a "friendly forum".

Our membership stands ready to provide whatever level of support is needed to advance this important legislation. As the national organization representing the decision makers within the American economic model who drive commerce, we hope you will ensure that Congressional leadership will take action on this bill as expeditiously as possible.

8840 Columbia 100 Parkway • Columbia, MD 21045-2158 • Phone: 410/740-5560 • Fax: 410/740-5574 • Website: www.nacm.org

Senator John Cornyn
January 31, 2005
Page Two

We must provide immediate relief to the small business that simply cannot afford to wait any longer for bankruptcy reform from Congress.

Thank you for your consideration of our comments and please let us know what we can do assist you in advancing this legislation.

Sincerely yours,

Robin Schausell, CAE
President

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Testimony of
The National Association of Federal Credit Unions

Committee on the Judiciary
United States Senate

Bankruptcy Reform

February 10, 2005

National Association of Federal Credit Unions
3138 10th Street North
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(703) 522-4770

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National Association of Federal Credit Unions
Bankruptcy Executive Summary Statement

In the twelve-month period that ended on December 31, 2004, NAFCU estimates over 1.6 million consumers filed for bankruptcy; with approximately 267,000 of those consumers being credit union members (estimates based on trends through 3rd quarter 2004 for consumer filings and 2nd quarter 2004 numbers for credit union member filings). Congress has recognized this trend and has taken action in an attempt to alleviate this problem with the introduction of the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, S.256.

Credit unions are member-owned not-for-profit institutions that serve a broad and diverse membership base, including many members of low and moderate means. Because of their cooperative form of ownership credit unions, have no choice but to pass bankruptcy losses on to financially responsible members through increased interest rates on loans or decreased dividend rates on savings. As the number of bankruptcy filings continues to rise, bankruptcy losses have a disproportionately heavier impact upon fiscally responsible credit union members than they do on the customers of for profit financial institutions.

NAFCU supports meaningful reform of the bankruptcy code that brings about both responsible lending as well as responsible spending. NAFCU believes that the bankruptcy reform legislation Congress has been working on over the past 7 years represents a well balanced approach and goes a long way toward making appropriate and long-needed reforms to the bankruptcy system.

Three issues have risen to the top of NAFCU's agenda with regard to bankruptcy reform. First, require the courts to conduct a "means" test to determine whether debtors who file for total elimination of their debts under Chapter 7 of the Bankruptcy Code have the resources to repay some portion of their debt, in which case they should be required to file under Chapter 13 or be dismissed out of bankruptcy. Second, require mandatory financial education for all filers. Credit unions have a history of educating their members in financial matters, including the wise use of credit and the value of systematic savings. Finally, preserve the right of voluntary reaffirmations for credit union members. Credit unions traditionally have higher reaffirmation rates than many other lenders, partly because their members realize that credit unions are cooperatives, and offer them low interest rates on loans and high dividend rates on savings.

As you know, the legislation introduced in the 108th Congress included these three important provisions that NAFCU believes are necessary in any reform effort. We are pleased to see that these provisions are again included in the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* and urge its quick passage.

Introduction

The National Association of Federal Credit Unions (NAFCU) is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU is comprised of approximately 800 federal credit unions -- financial cooperatives from across the nation--that collectively hold approximately 66 percent of total federal credit union assets; NAFCU represents the interests of approximately 26 million individual credit union members. NAFCU, and the entire credit union community, appreciates the opportunity to participate in the discussion regarding the need for reform of the nation's bankruptcy system.

Nature of Credit Unions

Historically, credit unions have served a unique function since Congress first authorized the establishment of federal credit unions:

- First, credit unions remain totally committed to providing their members with efficient, low-cost personal service.
- Second, credit unions continue to emphasize traditional cooperative values, such as democracy and volunteerism.

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

Credit unions play an important role in the financial lives of more than 85 million Americans from all walks of life who have chosen the convenient and low-cost financial services that only credit unions can provide. As the package of services offered by various types of financial institutions becomes more and more homogenized, the emphasis shifts from the type of

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service offered to the quality and cost of service provided. Historically, credit unions have been second to none in providing their members with quality personalized service at the lowest possible cost. According to an annual survey conducted by the *American Banker* newspaper, 2000 was the sixteenth consecutive year in which credit unions have rated higher than all other financial institutions in overall service quality and this trend shows no sign of change.

Need For Bankruptcy Reform

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

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

Costs of Bankruptcy

Nationally, consumer bankruptcies have spiraled upward. In 2003, the number of consumer bankruptcy filings remained high with approximately 1.6 million filings. Credit union members have not been immune to the rising trend in personal bankruptcies. In 2003 approximately 257,000 credit union members filed for bankruptcy. On average forty percent of all loan losses at federally insured credit unions in 2003 were due to bankruptcy. As of December 2003, $1.9 billion in loans was subject to bankruptcy, a 27 percent rise from the December 2002 level of $1.5 billion in loans subject to bankruptcy in 2002.

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Credit Union Response to Consumer Bankruptcy

Most credit unions have lower operating margins than other types of lenders. Typically, credit unions pay higher rates on savings and charge lower rates on loans than other financial institutions. Because of these smaller margins, credit unions are more heavily impacted than other financial institutions by escalating bankruptcy costs. A natural reaction for some institutions is to increase interest rates, but that is not what has happened in the credit union community. Credit unions keep interest rates as low as possible for the benefit of their members.

Credit unions also do much to promote financial responsibility among their members. Because credit union members pool their resources for the mutual benefit of all members, they have traditionally relied heavily on member education and individual counseling to encourage and promote financial responsibility.

Reform Efforts: Credit Union Perspective

Because of the rising number of personal bankruptcy filings, the credit union community believes that legislative action is necessary to improve the current bankruptcy system. In a recent survey of credit union management NAFCU found that 89% percent of credit unions still consider the issue of bankruptcy reform to be an important legislative issue. Among the top legislative priorities listed by our members include:

- requiring Chapter 13 consideration before establishing eligibility for Chapter 7
- strengthening the right of reaffirmation for credit union members
- requiring mandatory financial education for all bankruptcy filers

The results of this survey closely resemble the results of a survey done by NAFCU's Ad Hoc Bankruptcy Committee in 1997.

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In that survey NAFCU's Ad Hoc Bankruptcy Committee surveyed over 1,050 federally chartered credit unions. The survey revealed three issues that rose to the forefront of credit union's agenda regarding bankruptcy reform.

First is ***requiring Chapter 13 consideration before establishing eligibility for Chapter 7.*** Bankruptcy courts do not require any showing of need or minimum level of debt. The bankruptcy court simply accepts the debtor's assertion that bankruptcy is necessary. As a result, Chapter 7 often gives more relief than is truly necessary. The full discharge of debts provided by Chapter 7 is a carryover from the last century, when most credit was secured by tangible assets. Today's consumer-based economy is built on unsecured revolving credit with the promise that debtors will pay from future income. Approximately 97 percent of the respondents support a bankruptcy system that is needs-based. This would help to increase debtor accountability, create a fairer bankruptcy system, and more fairly distribute payments among all creditors.

Second is ***mandatory financial education for all bankruptcy filers.*** Credit unions have a long history of educating their members in financial matters. The wise use of credit as well as the value of systematic savings are basic credit union principles. Most credit unions attempt to provide the best possible education for their members. Of those surveyed by NAFCU, 84 percent support a requirement that debtors participate in credit counseling before filing bankruptcy.

Third is ***strengthening the right of reaffirmation for credit union members.*** Credit unions traditionally have higher reaffirmation rates than many other lenders, partly because their members realize that credit unions offer them low interest rates on loans and high dividend rates on savings. The higher credit union reaffirmation rates reflect other characteristics of the credit union philosophy such as the knowledge that fellow credit union members will bear the costs of any debt discharged in bankruptcy. Credit unions believe that their members should be assured that they can retain their relationship with their financial institutions by reaffirming loans at reasonable rates, rather than being forced to pay higher prices elsewhere. Seventy-six percent of those surveyed believe that the bankruptcy code should not include any limitations on the right to

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reaffirm.

Over the last five years NAFCU has also recommended additional changes to the bankruptcy code. They include:

- Establishing uniform exemptions. At present, exemption levels vary greatly from state to state. The present range is from $5,000 to essentially unlimted amount in a few states. This money should be used to pay the debtor's bills, rather than serving as a bonus to the debtor while creditors take a loss.

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

- Extending bilateral netting provisions to credit unions as well as other financial institutions. Bankruptcy reform legislation in the 108th Congress would have allowed for efficient and expedient settlement of bilateral netting agreements. The financial services industry considers bilateral netting essential to ensuring that the insolvency of one institution does not have a domino effect on other institutions that could lead to disruptions in the money supply.

Reform Efforts: Congressional Action

Despite all of the efforts to educate, to make sound loans, and to assist those in trouble, bankruptcy reform is needed to encourage financial responsibility. NAFCU believes that S. 256 is a well balanced approach and goes a long way toward making appropriate and long-needed reforms to the bankruptcy system. NAFCU is particularly pleased with the provisions that

preserved the right of credit union members to voluntarily reaffirm their debts; required debtors to obtain financial counseling upon filing; and, required debtors who have the means to do so to repay what they can before receiving a discharge in bankruptcy.

Conclusion

Congress should consider a wide range of issues to foster responsibility and accountability among all persons involved in the personal financial services arena. These issues include strengthening the educational system, thoroughly evaluating lending practices, enacting a needs-based bankruptcy system that retains a credit union member's right to reaffirm his or her debts and streamlines uniform administrative procedures.

As bankruptcy filings increase, the burden on financial institutions also increases -- a burden that ultimately is shouldered by the American consumer. NAFCU recognizes the need for reform and is grateful that Congress is focused on the problem and is determined to implement reforms. NAFCU hopes that the Senate Judiciary Committee passes S. 256 and the full Senate send the bill to the House for consideration.

On behalf of NAFCU, thank you for considering the credit union perspective. NAFCU applauds the efforts of the Committee and hopes to continue to work with you to resolve this and other challenging issues.

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STATEMENT OF THE
NATIONAL ASSOCIATION OF REALTORS®
AND THE INSTITUTE OF REAL ESTATE MANAGEMENT®
TO THE
SENATE COMMITTEE ON THE JUDICIARY
ON
BANKRUPTCY REFORM

FEBRUARY 10, 2005

The NATIONAL ASSOCIATION OF REALTORS®, and its affiliate, the Institute of Real Estate Management® , support S. 256, the ''Bankruptcy Abuse Prevention and Consumer Protection Act of 2005''. The NATIONAL ASSOCIATION OF REALTORS® is comprised of over one million real estate professionals involved in all aspects of the real estate industry, including the owners and managers of multifamily rental and commercial property. The Institute of Real Estate Management® is comprised of over 9,000 property management professionals who manage over 24% of the nation's privately owned residential apartment properties, 44% of the nation's office buildings, and 10% of the nation's retail space.

For a number of years Congress has come close to achieving bankruptcy reform. We commend Senator Charles Grassley (R-IA) for continuing to introduce this important legislation. There are four main issues of bankruptcy reform which specifically concern our members.

The first of these is single asset bankruptcy. Single asset real estate refers to a single property or project, which generates substantially all of the gross income of a debtor, and on which the debtor conducts no substantial business other than the business of operating the real property. The related provision of the Code subjects single asset properties with a value of less than $4 million to an automatic stay from creditors for 90 days. However, the stay for properties of over $4 million can last for 6 months to well over a year. As there seems to be no justification for differentiation between properties based upon their value, and certainly property values differ in different geographic jurisdictions, we believe that the 90 day automatic stay should apply to all single asset properties, with no cap on the value of the asset. S. 256 would eliminate the cap, treating all single asset bankruptcies the same, regardless of their value.

A second issue deals with automatic stay provisions in rental housing. Section 362 of the Code provides for an automatic stay, which is intended to provide debtors with due process protections. However, the Code does not specify to which assets the automatic stay applies. Due to this silence, some tenants are attempting to avoid eviction by filing for bankruptcy and listing the apartment as an asset protected by the automatic stay. This occurs despite the fact that a tenant-debtor does not have a legal or equitable interest in an apartment for purposes of liquidation or reorganization under the Code (i.e. the apartment is the property of the rental

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housing provider – NOT the tenant). Unscrupulous tenants use this loophole in the Code to abuse the bankruptcy system and live rent-free. Furthermore, there has been a growth of unethical companies who, for a fee, will counsel tenants to abuse the Code in this manner to obtain free rent. By closing this loophole, and not allowing bankruptcy to be a stay from eviction, S. 256 will curb an abusive use of the Code. It will not change any of the protections currently enjoyed by tenants under state landlord-tenant law and will not affect other creditors because it only allows rental housing providers to regain possession of the apartments and not back rent. Housing providers, like other small businesses, will be required to comply with the Code with respect to recovering unpaid debts.

The third issue deals with shopping center bankruptcy. Under current law, shopping center tenants who declare bankruptcy have 60 days to decide to assume or reject their lease. However, courts routinely extend this time for months, and sometimes years. Due to the delicacies of the landlord/tenant relationship in shopping centers, the impact of this delay can be severe. At a minimum, a shopping center owner faces uncertainty as to whether the tenant will on short notice, reject the lease and terminate rental payments; the impact of that uncertainty on lease-up or sales of the centers and/or redevelopment efforts; and if the store has gone "dark"; interruption of percentage rents, diminished retail synergy and cross sales in the center and potential co-tenant exercises of rent abatement or escape provisions of leases tied to co-tenancy. The discretion of the courts to provide multiple, lengthy extensions of deadlines to assume or reject leases should be constrained by statute. We support increasing the initial time for a tenant to make this decision to 120 days with one extension of 90 days for cause; further extensions must be made only upon a motion of the lessor.

The final issue of importance to the real estate industry pertains to fees arising from ownership interests in real property. Under current law, fees owed to homeowners associations, condominiums and cooperatives are often discharged, leaving the remaining property owners to make up these costs. Common interest communities face increasing fees due to the "free ride" bankrupt owners in condominiums and cooperatives are given at the expense of their neighbors. We support the provision to provide that fees or assessments that accrue while the debtor has an ownership interest in a homeowners, community, or condominium association are non-dischargeable.

The NATIONAL ASSOCIATION OF REALTORS® and the Institute of Real Estate Management® support responsible bankruptcy reform. We believe these common sense reforms will curb abusive use of the Bankruptcy Code. We support S. 256, and thank Senator Grassley for his efforts towards bankruptcy reform.

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February 8, 2005

VIA FACSIMILE 228-2281

Mr. James Ho
Chief Counsel
U.S. Senate Judiciary Subcommittee
Dirksen Senate Office Building, Room 139
Washington, DC

Re: Bankruptcy Reform Act

Dear Mr. Ho:

I am pleased to be able to present, for consideration by Senator Cornyn, the Subcommittee members, and yourself, some thoughts concerning amendments to the pending legislation on venue in bankruptcy cases.

Bankruptcy law is unique in that there are no jurisdictional requirements. Venue considerations are somewhat controlling but can be ignored. For certain, these considerations afford astute counsel many options for the filing of cases.

The biggest benefactor is the Bankruptcy Court in Delaware. As you are no doubt aware, the situation became so tainted a few years ago, that the District Court took over the management of cases for a significant period of time.

Counsel choosing venue select a site, even if the connection to the case is slim, because of comfort about first day orders, fees, critical vendor questions and general case management. In many instances, venue choices create a significant disconnect between the debtor and the community which has a great stake in its future. In those instances, local parties are discouraged from taking an active role, a result distinctly opposite one of the foundations of the Code–a strong, interested creditor body.

Venue choice resurrects the ghosts of bankruptcy rings of not so long ago. With bankruptcy playing an increasingly large role in the financial world in which we all live, it is important that the connection between company and community be maintained.

I would also note that such restrictions would probably result in some economies to the estates in that the level of rates charged would be reduced.

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SPENCER FANE
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Mr. James Ho
February 8, 2005
Page 2

Thank you for the opportunity to present my views.

Yours very truly,

Joel Pelofsky

JP/kl

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A PROPOSAL FOR MORE EFFECTIVE BANKRUPTCY REFORM
By A. Thomas Small and Eugene R. Wedoff

Introduction

This Proposal addresses the goals of bankruptcy reform advanced in the last several sessions of Congress and most recently incorporated in S. 256 in the 109th Congress. The Proposal furthers the principal objective of the reform legislation—to curb bankruptcy abuse— both by making bankruptcy relief more difficult for the most likely abusers and by adjusting procedures that could impair the goals of the legislation by imposing unnecessary costs on parties and the court system.

The Proposal is set out in 15 separate recommendations, followed by a summary table. For several of the recommendations, statutory language is provided to effect all or part of the changes recommended. The recommendations for individual bankruptcy cases (1) make the reform provisions applicable to *all* debtors, rather than limiting them to debtors with primarily consumer debts, (2) expand the criteria for determining abuse to include both ability to pay and the amount of property exempted, and (3) maintain incentives for debtors to choose repayment of their debts through a Chapter 13 plan. The recommendations for business bankruptcy are consistent with the objective of expediting the confirmation process, reducing costs for both debtors and creditors, and providing increased oversight.

The Proposal is limited to those areas with the greatest impact on the bankruptcy system, and does not address all of the provisions of S. 256. The failure to comment on a particular section of the legislation reflects neither support of nor disagreement with that section.

Proponents

A. Thomas Small has been a United States Bankruptcy Judge for the Eastern district of North Carolina for 20 years and served a 7-year term as Chief Judge from 1992 to 1999. His involvement with bankruptcy reform began in the early 1980s. As an attorney in the Legal Division of First Union National Bank and as a representative of the American Bankers Association and the National Coalition for Bankruptcy Reform, Judge Small participated in hearings on bankruptcy abuse conducted by Senator Robert Dole, Chair of the Senate Judiciary Committee's Subcommittee on Courts, and by Representative Peter Rodino, Chair of the House Judiciary Committee. These reform efforts led to significant amendments to the Bankruptcy Code, including the addition of § 707(b) and amendments to § 523 to discourage the "loading up" of pre-bankruptcy debt. In 1985, Judge Small, along with Judge Thomas M. Moore (B.J., E.D.N.C.) testified before a joint Senate committee chaired by Senators Charles Grassley and John East regarding agricultural bankruptcies. Together with Judge Keith Lundin (B.J., M.D. Tenn.), Sam Gerdano (majority counsel for the Senate Judiciary's Subcommittee), and Vince Lavoi (legislative aid to Rep. Mike Synar), Judges Small and Moore drafted Chapter 12, which became part of the Bankruptcy Code in 1986. In 1987, Judge Small developed a fast track procedure for handling small business Chapter 11 cases. These procedures have been adopted in many districts and are the basis of many of the present small business provisions in the Bankruptcy Code and in S. 256.

Judge Small is the former chair of the Advisory Committee on Bankruptcy Rules of the United States Judicial Conference, was a member of the Long Range Planning Committee of the United States Judicial Conference from 1991 to 1996, and was a member of the Board of the Federal Judicial Center from 1997 to 2001. He was president of the National Conference of Bank-

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ruptcy Judges (2000-2001), served on the Board of the American Bankruptcy Institute from 1989 to 1995, and currently is on the Board of the American College of Bankruptcy.

Eugene R. Wedoff is the Chief Bankruptcy Judge for the Northern District of Illinois, in Chicago. He has been serving as a bankruptcy judge in that district for 17 years. After graduating from the College and Law School of the University of Chicago, Judge Wedoff became a partner and member of the Executive Committee at the Chicago law firm of Jenner & Block, specializing in the defense of businesses and individuals in complex civil litigation. Judge Wedoff is presently presiding over the bankruptcy of United Airlines and its related entities.

In 1997, Judge Wedoff became co-chair of the Consumer Bankruptcy Committee of the American Bankruptcy Institute. In that capacity, he has prepared analyses of the bankruptcy reform legislation presented in the last several terms of Congress, and testified concerning the legislation before the House Subcommittee on Commercial & Administrative Law. For his work in this area, Judge Wedoff received a special award from the ABI in 1998. Judge Wedoff has also engaged in discussions regarding bankruptcy reform as a participant in the Annual Bankruptcy Conferences sponsored by Visa USA, and has been a member of the Visa Bankruptcy Roundtable. An advocate of the Chapter 13 bankruptcy system, Judge Wedoff drafted the model Chapter 13 plan now used in the Northern District of Illinois and introduced that District's model retention agreement, which sets out the duties owed by debtors' attorneys to their clients.

Judge Wedoff is the author of the chapter on professional employment in Queenan, Hendel and Hillinger, *Chapter 11 Theory and Practice* (LRP Publications, 1994), and has served as an associate editor of The American Bankruptcy Law Journal and as a member of the Board of Governors of the National Conference of Bankruptcy Judges. He is a director and member of the executive committee of the American Bankruptcy Institute, a Fellow of the American College of Bankruptcy, and a member of the National Bankruptcy Conference.

The Proposal

1. Section 707(b), abuse, means testing

Recommendation

1) Change "substantial abuse" to "abuse" in § 707(b) [same as S. 256, § 102(a)(2)].

2) Remove the presumption in favor of the debtor's choice of relief in § 707(b) [same as S. 256, 102(a)(2)].

3) Expand the scope of § 707(b) to include *all* individual debtors, not just those with "primarily consumer debts" [new, modifies S. 256, 102(a)(2)].

4) Expand the criteria for § 707(b) "abuse" to include (1) the ability to repay general unsecured debt at a rate of at least $150 monthly, and (2) the totality of the debtor's circumstances, with specific reference to the extent of exemptions claimed by the debtor and to the intent of the debtor to reject a personal services contract [new, modifies S. 256, 102(a)(2)].

5) Clarify income measurement for purposes of § 707(b) to require that the determination of abuse be based on the debtor's projected earnings, considering both the debtor's income

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at the time of filing and the debtor's income for the preceding calendar year [continues approach of S. 256, 102(a)(2) by considering past earning history, but eliminates difficulties caused by 6-month averaging].

6) Permit creditors to file motions to dismiss under § 707(b) if the debtor's current or prior year income exceeds the applicable state median [expands approach in S. 256, § 102(a)(2)].

7) Determine debtor's expenses on an actual and necessary basis, without application of IRS standards [new, modifies S. 256, 102(a)(2)].

8) Provide for a study of the effect of employing IRS standards or other measures of appropriate living expenses in determining abuse under § 707(b) [same as S. 256, 103(b), but with the study preceding the use of IRS standards].

Comment

Perhaps the most important change proposed in S. 256 is its "needs-based" approach to Chapter 7 relief. This approach is designed to limit Chapter 7 relief to debtors who genuinely need it, because their income is not sufficient to pay both their living expenses and their debts. S. 256 effectuates needs-based Chapter 7 relief through amendments to § 707(b) of the Code. Section 707(b) currently allows dismissal of Chapter 7 cases for "substantial abuse," with the understanding that it would be a substantial abuse for a debtor to seek an immediate discharge in Chapter 7 if the debtor could repay debts from current income, under Chapter 13 if necessary. However, § 707(b) has had limited impact—for several reasons: (1) only judges and the U.S. trustee or bankruptcy administrator have standing to bring a § 707(b) motion; (2) the provision is limited to debtors with primarily consumer debts; (3) it contains no definition or description of "substantial abuse"; and (4) it includes a presumption that the debtor has properly chosen to proceed in Chapter 7.

S. 256 amends § 707(b) to accord standing to all parties in interest if the debtor's average monthly income over a six-month period exceeds a defined state median; it allows dismissal for simple "abuse" rather than "substantial abuse"; it describes abuse as involving the totality of the debtor's financial situation; it eliminates the presumption in favor of the debtor's choice of Chapter 7; and it creates a new presumption: that abuse exists in any case where the debtor's average monthly income over six months—less deductions for living expenses and payment of secured and priority debt—exceeds defined "trigger points." For purposes of this presumption, the debtor's expenses are based, in part, on standards developed by the IRS for negotiating payment of tax liabilities from delinquent taxpayers.

S. 256's approach is problematic in two respects. First, it continues the current limitation of § 707(b) to debtors with primarily consumer debts, with the effect of excluding from its scope wealthy debtors with substantial business liabilities. Second, its presumption of abuse is complex, and creates substantial difficulties in calculating both income and allowable expenses. Six-month income averaging produces skewed results for debtors with seasonal employment, and fails to take into consideration recent changes in employment. Moreover, the IRS collection standards for expense allowance, which are complex in their own right, were not created for use in bankruptcy, and so S. 256 contains numerous provisions modifying or supplementing them (for example, one provision requires that the IRS standards be adjusted to eliminate any expense attributable to secured debt repayment, since such payments are allowed as a separate deduction). As a result, the presumption is difficult to apply and subject to manipulation. It also imposes sub-

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stantial costs on all debtors, regardless of their ability to pay debts, as well as on trustees and the court in administering the presumption.

To achieve the goal of needs-based Chapter 7 more effectively, the Proposal suggests retaining the overall modifications to § 707(b) set out in S. 256 as follows: (1) changing "substantial abuse" to simple "abuse"; (2) removing the presumption in favor of the debtor's choice of Chapter 7 relief; (3) defining "abuse" to include consideration of the debtor's ability to pay general unsecured debt at a defined level; (4) considering the debtor's past earnings in determining ability to pay; and (5) extending standing to creditors and case trustees where the debtor's income exceeds the applicable state median. However, the Proposal would delay application of a presumption of abuse until the completion of a study of the potential use of IRS collection standards for this purpose, as directed by § 103(b) of S. 256.

At the same time, the Proposal suggests the following additional provisions to make § 707(b), as amended, more effective:

• Remove the "primarily consumer debt" limitation, so that § 707(b) is applicable to all individual Chapter 7 debtors.

• Allow the expanded standing for parties in interest to be based on the debtor's prior year's gross income, as well as on current income.

• create a single, clear "trigger point" of $150 per month ($1800 annually), at which available income to pay general unsecured debts will constitute abuse of Chapter 7. The trigger points for the presumption of S. 256 range from $100 per month to $166.67 per month, depending on the total amount of general unsecured debt. This range creates complexity, and provides incentive for debtors to increase their debt prior to bankruptcy so as to avoid a finding of abuse.

• Specify that, in calculating the amount of income the debtor has available to pay general unsecured debt, the debtor's projected earnings be used, determined by the debtor's earnings history as well as the debtor's current earnings. Specify further that the expenses claimed by the debtor must be the debtor's actual expenses, in amounts reasonably necessary to provide for the maintenance or support of the debtor and the debtor's dependents.

• Clarify that the "totality of the circumstances" may lead to a finding of abuse even where the debtor has not been shown to have ability to repay debt above the trigger point, and that, in this regard, the court may consider the extent of the exemptions claimed by the debtor as well as bad faith and the intent by the debtor to reject a personal services contract.

Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

2. Random audits; attorney liability for accuracy of schedules

Recommendation

1) Provide for random audits of all individual debtors, conducted by auditors approved by the U.S. trustee or bankruptcy administrator; provide for the cost of such audits to be borne by the U.S. trustee system unless a willful, material misstatement is established; in

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case of such a misstatement, provide for the audit cost to be assessed against the debtor [consistent with, but expanding on S. 256, § 603].

2) Eliminate increased liability for debtor's counsel beyond that currently required by Rule 9011, FRBP [omits additional liability provided in S. 256, §§ 102(a), 319].

Comment

Random audits. In order for the bankruptcy system to operate fairly, it is essential that the information provided by debtors in their schedules be accurate. To achieve greater accuracy S. 256 provides for random audits of not less than one in every 250 cases of individual debtors (0.4%). If the cost is $1500 for each audit, and individual bankruptcy cases continue to be filed at the current rate (1.5 million annually), the total annual cost to audit 0.4% of the cases would be $9 million. S. 256 does not address payment of the costs of these audits.

Random audits have the potential to be effective in encouraging accuracy by debtors. At the same time, the question of payment for the audits must be addressed. Most Chapter 7 debtors have no assets available to pay the costs of an audit. Chapter 13 debtors often are required to devote nearly all of their debt repayment to priority and secured indebtedness, which must be paid in full, leaving little for payment of general unsecured claims. A requirement that such debtors bear the cost of an audit would be very difficult to enforce, and likely cause the failure of many Chapter 13 plans. Thus, as a general rule, the costs of the audits should be borne by the U.S. trustee system, with funding provided to that system for this purpose. On the other hand, where a random audit reveals a willful, material misstatement by the debtor, it is appropriate for the audit costs to be assessed against the debtor; the imposition of such costs will serve as an additional incentive for accuracy.

Attorney liability. The burden of full and accurate disclosure in bankruptcy schedules is properly placed on the debtor. With the addition of random audits, there should be no need for the enhanced liability that S. 256 would impose on debtors' attorneys to investigate the accuracy of schedules. Requiring such investigation would increase the cost of legal representation and interfere with the attorney-client relationship.

3. Conditions precedent for relief (credit counseling, financial documentation, education)

Recommendation

1) Require credit counseling as a condition of eligibility for individual Chapter 7 debtors [same as S. 256, § 106(a), but limited to Chapter 7].

2) Require debtors to produce proof of earnings to the trustee, prior to the § 341 creditors meeting, rather than filing the documentation with the court; provide that if the debtor fails to produce information required under § 521 of the Code, the court must dismiss the case on motion of a party in interest, unless (a) the debtor demonstrates that the failure was due to circumstances beyond the debtor's control or (b) the trustee establishes grounds for seeking a denial of discharge or administering the estate for the benefit of creditors [modifies S. 256, §§ 315(b) and 316].

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3) Commence a program of mandatory debtor education only after consideration of a study of the effectiveness of various educational methods [retains S. 256, § 105; defers S. 256, § 106(b)].

Comment

Credit counseling. Section 106(a) of S. 256 requires that each individual debtor obtain a briefing from a credit counseling agency as a condition of eligibility for bankruptcy filing. The briefing would inform the debtor of the opportunities for credit counseling and assist the debtor in performing a budget analysis. Such a briefing could be helpful to Chapter 7 debtors. A Chapter 7 debtor may not have carefully considered the possibility of paying creditors over time through available income, and a limited delay in filing the case to allow for a credit counseling briefing is unlikely to cause significant difficulties, since Chapter 7 is not generally used to prevent foreclosures or repossessions.

In contrast, credit counseling briefings are not likely to be helpful in Chapter 13. A Chapter 13 debtor must propose a budgeted repayment plan as part of the bankruptcy process, and so any budgeting work done with a credit counselor would be duplicative, adding unnecessary expense. Moreover, Chapter 13 debtors frequently approach their attorneys shortly before a foreclosure sale or repossession, with a need to file the bankruptcy immediately if the threatened action is to be avoided. Any delay required to obtain counseling could cause the loss of property essential to the debtor's success in reorganizing under Chapter 13. (While S. 256 does provide an exception for filing in emergencies, it requires the debtor to establish that credit counseling services were unavailable for five days, and so the exception would not apply in situations where the attorney is contacted within five days of a threatened foreclosure or repossession.) Limiting the credit counseling requirement to Chapter 7 debtors would provide maximum value, limit unnecessary expense, and provide a valuable incentive for debtors to file under Chapter 13.

Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

Financial documentation/dismissal for failure to produce. Section 521 of the Code sets out the duties of debtors, including the duty to file schedules. Section 315(b) of S. 256 imposes several additional duties on individual debtors, including a duty to file with the court "copies of all payment advices or other evidence of payment received within 60 days before the filing." Such payment advices are likely to include identifying information of a personal nature (including social security numbers) that would be difficult for the court to protect from disclosure. For tax returns filed prior to the bankruptcy, § 315(b) provides that the debtor is not required to file the information with the court, but to provide it to the trustee at least seven days before the creditors' meeting. By treating payment advices in the same way, the problems of protecting privacy can be avoided.

Sections 315(b) and 316 of S. 256 set out a complex set of rules for dismissal of individual bankruptcy cases in situations where the debtor fails to submit required financial information. In some situations, dismissal is required automatically, without notice to the debtor. In others, dismissal is required unless there is a showing of good faith on the debtor's part, or a showing that circumstances beyond the debtor's control prevented timely production of the documents. Automatic dismissal is problematic, in that neither the debtor nor the trustee may be aware of any deficiency in providing required information; and, dismissal in the absence of a showing of good faith by the debtor may prevent a trustee from seeking a denial of the debtor's discharge or the recovery of avoidable transfers. It is preferable to require a motion for dismissal based on the

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00166 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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debtor's failure to provide required information, and to allow denial of the motion if the debtor shows the existence of circumstances beyond the debtor's control, or the trustee shows good cause to continue administering the case for the benefit of creditors.

Debtor education. Section 105 of S. 256 establishes a pilot educational program, in six judicial districts, designed to help individuals better manage their finances. The program would be studied by the Executive Office for United States Trustees, and would be followed by a report to Congress by the director of that office. The program, study, and report would be of great value. A number of educational programs already have been developed, primarily in the context of Chapter 13, and knowledge of their effectiveness would be very helpful to Congress in determining what type of educational program would be most effective in bankruptcy. For example, it might be determined that educational programs are much more effective in Chapter 13, where debtors are in contact with the bankruptcy process for an extended period of time, than they are in Chapter 7, where the debtor is generally involved in bankruptcy for only a few weeks.

In contrast to § 105, § 106(b) of S. 256 mandates debtor education in both Chapter 7 and Chapter 13 cases, on penalty of a loss of the bankruptcy discharge. It is premature to require completion of the educational programs before the results of the study. If it is determined, for example, that educational programs are not effective in Chapter 7, requiring completion of such programs will unnecessarily expend both the time and financial resources of debtors with limited income. Moreover, allowing completion of the study before mandating education will allow any mandated course of study to be based on the best available curriculum.

4. Reaffirmation agreements

Recommendation

1) Conduct a study to determine extent of any abuse and need for legislation [same as S. 256, § 205].

2) Defer modifying reaffirmation procedures until completion of the study [defers extensive and confusing reaffirmation requirements in S. 256, § 203].

Comment

Under present law counsel must certify that reaffirmation agreements (other than agreements involving a consumer debt secured by real property) do not impose an undue hardship on the debtor or a dependent of the debtor and that the agreement is in the debtor's best interest. 11 U.S.C. § 524(c)(6). If the debtor is not represented by an attorney in connection with the reaffirmation agreement, the court must hold a hearing at which it informs the debtor of the effect of the agreement and finds that the agreement (other than an agreement involving a debt secured by real property) does not impose an undue hardship on the debtor or a dependent and is in the debtor's best interest. 11 U.S.C. § 524(d). These requirements—attorney certification and court approval for agreements involving pro se debtors—may be adequate to protect the interests of debtors. The protections provided by S. 256 are cumbersome and should not be enacted until the study has been completed and a need for the additional protections has been established.

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5. Serial filers; relief from stay

Recommendation

1) Provide that, in a second bankruptcy case filed by a debtor within a one year period, the court shall enter an order terminating the automatic stay 30 days after the second petition is filed, without the need for a motion, unless prior to the expiration of 30 days the debtor demonstrates that the second case was filed in good faith or unless a trustee demonstrates the potential to administer particular assets for the benefit of the estate [consistent with S. 256, § 302 except that an order is required].

2) Provide that, upon a third bankruptcy filing by a debtor within a one year period, the court shall immediately enter an order terminating the automatic stay, without the need for a motion, except that the stay may be reinstated by the court if the debtor demonstrates that the third case was filed in good faith or if a trustee demonstrates the potential to administer particular assets for the benefit of the estate [consistent with S. 256, § 302 except that an order is required].

3) Provide in § 362(d) of the Code that, with respect to all personal property securing consumer debts in Chapter 7 cases, the court shall enter an order terminating the stay, upon motion, if there has been no redemption or reaffirmation with respect to the property within 45 days of the date first set for the first meeting of creditors, unless the trustee establishes that the property at issue is of consequential value or benefit to the estate, in which case the court shall order appropriate adequate protection of the moving party's interest [consistent with S. 256, § 304-05 except that an order on motion is required].

4) Provide in § 362(d) of the Code that, with respect to all personal property subject to an unexpired lease in an individual Chapter 7 case, the court shall enter an order terminating the stay, upon motion, if there has been no assumption of the lease within 45 days of the date first set for the first meeting of creditors, unless the trustee establishes that the lease at issue is of consequential value or benefit to the estate, in which case the court shall order appropriate adequate protection of the moving party's interest [consistent with S. 256, § 305 except that an order on motion is required].

5) Provide in § 362(d) of the Code that, in Chapter 11 cases of small business debtors, the court shall enter an order terminating the stay, upon motion, if in a prior small business case of the debtor (or of an entity that the debtor acquired) an order of dismissal or an order confirming a plan was entered less than two years prior to the order of relief in the pending case, unless the debtor shows (a) that the pending case was an involuntary one, filed without collusion with the debtor, or (b) that the need for filing the pending case arose from unforeseeable circumstances beyond the control of the debtor, and that a non-liquidating plan is probable [consistent with S. 256, § 441(2) except that an order on motion is required].

Comment

It is not uncommon for debtors to frustrate collection efforts of secured creditors by filing bad faith bankruptcy cases. That is unfair to the creditors and relief from the stay should be promptly granted in these cases, without unnecessary cost to the creditors, unless good grounds are shown for the stay remaining in effect. S. 256 provides in several sections for automatic non-application of the stay (with the stay either not going into effect, or terminating automatically,

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00168 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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without motion) in situations deemed to be potentially abusive. In each of these situations, the stay would be effective if the debtor or a trustee makes a specified showing of good faith. The problem with this approach is the uncertainty of whether or not the stay is applicable—that is, whether the predicates for non-application of the stay have occurred—and there is potential for confusion if the applicability of the automatic stay is required to be adjudicated in state court. Accordingly, it would be preferable for the circumstances set out in S. 256 to be additional grounds mandating relief from the stay through an order of the bankruptcy court. This will ensure that questions regarding the grounds for relief are adjudicated in a forum with experience in the application of the laws in question, and that any dispute over the application of the law is addressed in the federal appellate process. Specifically:

Repeat filings by individual debtors. Section 302 of S. 256 provides that the stay should automatically terminate after 30 days if there is a second filing by an individual debtor within one year, and not be applicable at all if there are more than two filings, unless the debtor takes action to show good faith. In addition to the problem of requiring state courts to determine any dispute as to whether these provisions are effective, § 302 does not provide an opportunity for a trustee to show that property in the estate has equity that could be used to pay debts other than that of the secured creditor seeking to proceed against the property outside of the bankruptcy. The recommendation would require the bankruptcy court to enter an order terminating the stay without motion or request of the creditor if the debtor or trustee does not make the appropriate showing; state courts could then rely on an order of the bankruptcy court in allowing actions against the debtor's property to proceed.

Redemption or reaffirmation. With respect to personal property that is collateral or subject to a lease, §§ 304 and 305 of S. 256 provide for automatic termination of the stay if the property is not subject to redemption or reaffirmation by an individual debtor within a specified 45-day period. The recommendation is for the court to enter an order terminating the stay if the debtor does not redeem or reaffirm a secured debt, or assume a lease, within the 45-day period. A motion would be required in these situations, since a reaffirmation agreement may not be of record. The motion would allow the trustee to present evidence of equity to the court, so as to allow the trustee to sell the property or assume the lease in question for the benefit of the estate.

Repeat filings by small business debtors. Section 441(2) of S. 256 provides for non-application of the automatic stay in situations of repeat filings of small business Chapter 11 cases. Here, especially, there are likely to be questions as to whether the grounds for non-application apply. For example, § 441(2) provides that an entity that acquires "substantially all of the assets or business" of a small business debtor under a confirmed plan would not get the benefit of the automatic stay in its own small business bankruptcy for a two-year period after the order of confirmation in the original case, unless it showed that the acquisition was in good faith and not for the purposes of avoiding application of the automatic stay limitation. This provision is subject to considerable potential dispute—both as to the question of whether "all or substantially all" of the business was acquired, and whether the acquisition was in good faith. It is better to allow these matters to be resolved in the bankruptcy court, with appeal through the federal courts, rather than in state court. This, again, can be accomplished by mandating that relief from the stay shall be granted on motion on the grounds set forth in § 441(2).

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6. Notice to creditors

Recommendation

> Continue the current law on noticing pending a study of electronic notice to creditors, conducted by the Administrative Office of the United States Courts. [modifies S. 256, § 315(a)].

Comment

Section 315(a) of S. 256 sets out a new program for providing notice to creditors, requiring that they be served at a preferred address, which may be on file with the court generally, on file with the court in a particular case, or listed in the two most recent pieces of correspondence sent to the debtor within the 90 days preceding the bankruptcy filing, unless the creditor was prohibited from communicating with the debtor during that period, in which case the required address would be the one used on correspondence sent to the debtor prior to the 90-day period. If the preferred address is not used, the debtor or trustee would have the burden of showing that notice was actually received by the creditor's designated office in order for certain enforcement actions to be taken against the creditor.

The Administrative Office of the United States Courts is currently in the midst of a transition to electronic filing for the federal judiciary, in which bankruptcy courts are taking the lead. Participants in the electronic filing program will be able to receive electronic notice of filings, via the Internet, almost as soon as the filing takes place. This system offers possibilities for effective notice, on a nationwide basis, that can avoid the uncertainty and potential for litigation involved in the program set out in § 315(a). Accordingly, it is proposed that the current law on noticing be continued pending a study of electronic notice to creditors, conducted by the Administrative Office.

Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

7. Time between discharges

Recommendation

> Retain current law regarding the effect of prior bankruptcy discharges on the ability of the debtor to obtain a discharge in Chapter 13 [modifies S. 256, § 312].

Comment

Section 312 of S. 256 changes current law regarding the effect of prior bankruptcy cases on the ability of an individual to obtain a discharge in a pending case. Under current law (§ 727(a)(8)), a Chapter 7 debtor is subject to denial of discharge if the debtor obtained a discharge in a Chapter 7 or 11 case filed within six years of the pending case. S. 256 extends this time to eight years—a change not affected by this Proposal.

However, § 312 also creates, for the first time, a limitation on the ability of a Chapter 13 debtor to obtain a discharge, by providing that a discharge will not be granted in Chapter 13 if the debtor obtained a discharge in a Chapter 7, 11, or 12 case filed within four years of the pending

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case, or in a Chapter 13 case filed within two years of the pending case. This provision has the effect of denying any possibility of a bankruptcy discharge, for four years, to an individual who has obtained a Chapter 7 discharge.

For an individual who is again in financial distress after obtaining a Chapter 7 discharge, Chapter 13 may be the most effective means for financial restructuring. Since the discharge could only be granted if the debtor devotes all disposable income to plan payments for a minimum of three years (or pays 100% of all claims), Chapter 13 may well create a framework of financial responsibility that will prevent further difficulties.

The principal problem of allowing a debtor to file Chapter 13 shortly after a Chapter 7 case is concluded has to do with the so-called "Chapter 20" abuse—in which debtors who could have addressed all of their debt in Chapter 13 instead file Chapter 7 cases, obtain a discharge of their unsecured debt, and then pursue Chapter 13 only to deal with the remaining secured debt. This type of abuse is dealt with by current law requiring that Chapter 13 cases be filed in good faith (a requirement confirmed by S. 256, § 102(g)), and by new limitations on the effect of the automatic stay included in S. 256, § 302 as discussed above in Recommendation 5. Denying a discharge to a debtor in the "Chapter 20" situation would have no impact in any event, because the Chapter 13 debtor would already have received a discharge in the prior Chapter 7 case, and would be using the Chapter 13 only to restructure nondischargeable secured debt.

8. Dischargeability

Recommendation

1) create a new ground for nondischargeability under § 523(a) dealing specifically with misuse of credit card obligations, and provide that the new ground for nondischargeability is not applicable to a discharge under § 1328(a) of the Code [modifies S. 256, § 314(b)].

2) Remove § 523(a)(1)(B) from the categories of nondischargeable tax debt as to which a discharge under § 1328(a) does not apply [modifies S. 256, § 707].

Comment

In the area of the dischargeability of debt, S. 256 makes a substantial change in current law, largely eliminating the "superdischarge" feature of Chapter 13. Under current law, a full Chapter 13 discharge, as provided for by § 1328(a), applies to a number of debts that are nondischargeable under other chapters of the Code, including the following:

- § 523(a)(1)(B) and (C) (debts arising from late-filed and fraudulent tax returns),
- § 523(a)(2) (debts incurred through fraud),
- § 523(a)(3) (debts held by creditors who received inadequate notice of the bankruptcy filing),
- § 523(a)(4) (debts for embezzlement and breach of fiduciary duty), and
- § 523(a)(6) (debts from willful and malicious personal injuries or wrongful death).

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Except for willful injuries to property, all of these debts would no longer be dischargeable in Chapter 13. While most of these changes in the law would have a relatively small impact on the overall operation of the Chapter 13 process, two of the changes would make Chapter 13 much less effective, and so are proposed to be modified here. Specifically, the Proposal recommends retaining the superdischarge as to credit card misuse and tax debt arising from late-filed returns.

Credit card misuse. Credit card misuse is the most commonly encountered form of nondischargeable debt in Chapter 7. Debts arising from credit card misuse are currently excepted from discharge under the fraud exception of § 523(a)(2). However, the application of this provision to credit card misuse has been problematic, since there is no actual contact between the debtor and the credit issuer at the time the credit card is used. For that reason, the traditional fraud elements of misrepresentation by the debtor and reasonable reliance by the creditor have been difficult to define. Creation of a new ground for nondischargeability, dealing specifically with credit card misuse, would resolve a number of conflicting approaches under the current law. Debts incurred with a credit card would be nondischargeable if, at the time of the transaction in question, the debtor intended to file a bankruptcy case or otherwise did not intend to repay the debt. Misrepresentation and reliance would not be relevant, and the presumption of § 523(a)(2)(C) (as amended by § 310 of S. 256) would be fully applicable.

The discharge under § 1328(a) should continue to apply to credit card misuse. This element of the Chapter 13 superdischarge is significant in any situation where a debtor has incurred questionable credit card debt. Under current law, such a debtor has a significant incentive to file under Chapter 13. Even though the debtor may have a colorable defense to a dischargeability complaint in Chapter 7, and even though Chapter 13 would require the debtor to complete a minimum three-year plan (or pay all debts in full) in order to obtain the discharge, the debtor would still likely choose Chapter 13, since that choice would avoid the expense of litigating the question of dischargeability, and offer the debtor a certain discharge if the plan is completed. If debts from misuse of credit cards are not dischargeable in Chapter 13, the incentive is reversed, with the debtor better off filing under Chapter 7. Chapter 7 would provide an immediate discharge of all other obligations and allow the debtor to use post-filing earnings to pay only the questionable credit card debt, while Chapter 13 would require the debtor to make partial payment of all unsecured debts, only to have the balance of the credit card debt still owing at the end of the plan.

Tax debt. The superdischarge should also continue to apply to tax debt arising from late-filed returns. Virtually all such debt is within the priority established by current § 507(a)(8), and so would have to be paid in full in any Chapter 13 plan under current § 1322(a)(2). However, making a debt nondischargeable, in addition to its status as a priority debt, has the effect of continuing interest and penalties. For late tax obligations, interest and penalties can be significant. Since the debt must be paid in full, the continuation of interest and penalties may make completion of a Chapter 13 plan impossible for many debtors with late filed claims, and again, give these debtors a substantial incentive to file under Chapter 7 rather than Chapter 13. This recommendation would not affect the provision of S. 256 denying a discharge under § 1328(a) to fraudulently incurred tax debt.

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9. Treatment of secured debt in Chapter 13

Recommendation

1) Continue current law allowing a Chapter 13 plan to bifurcate a claim secured by property other than residential real estate, with the secured portion of the claim accorded the replacement value of the collateral under § 506(a) of the Code, but provide in addition that the holder of a purchase money security interest in personal property acquired by the debtor within one year prior to the bankruptcy filing may elect to require the debtor to surrender the collateral [modifying S. 256, § 306].

2) Continue current law allowing § 506(a) valuation to vary according to the purpose for which the valuation is made [omits S. 256, § 327].

3) Clarify that holders of secured claims treated by a Chapter 13 plan must credit payments made under the plan consistent with the plan provisions [redrafting S. 256, § 202].

4) Require preconfirmation adequate protection payments (in the amounts proposed by the plan) to be made by the Chapter 13 trustee from payments made by the debtor to the trustee [modifying S. 256, § 309].

Comment

Bifurcation. Section 306 of S. 256 changes the current treatment of secured debt in Chapter 13. Current law provides debtors with the possibility of retaining property that is collateral for loans taken out by the debtor by paying the secured creditor the value of that property instead of the full amount of the debt that the property secures. For example, if a debtor owed $10,000 on an auto loan, but the vehicle securing the loan was only worth $7,000, the debtor would pay $7,000 (with interest) over the course of the Chapter 13 plan, and treat the $3,000 difference as an unsecured debt, payable at the same rate as other unsecured debts (such as credit card obligations). This process of reducing the amount of secured claims to the value of the collateral is referred to as "bifurcation" or "stripdown." This process is fairer to creditors, since it gives secured creditors the value of their collateral, but otherwise allows them to be paid on the same basis as other creditors. At the same time, bifurcation allows Chapter 13 debtors to prevent repossession of property that they need for employment or family support. Many debtors file Chapter 13 rather than Chapter 7 cases in order to obtain this benefit.

Section 306(b) of S. 256 would greatly reduce this incentive for use of Chapter 13. It would eliminate bifurcation for any motor vehicle loan incurred within 2-1/2 years of the bankruptcy filing and for any secured debt incurred within one year of the filing. Thus, the lender on a two-year old auto loan would have to be paid in full if a Chapter 13 debtor wished to retain the car that was collateral for the loan, even if the car was worth much less than the loan balance. This would be a windfall for the lender, who would receive much more than if the car were repossessed, and it would be a detriment to other creditors in the case, who would receive correspondingly less on their claims. Moreover, the extra payment required for secured debt would make Chapter 13 cases impossible for many debtors who now successfully complete them, whenever their income was not sufficient to pay both the increased amount on their secured claims and to pay other claims that Chapter 13 requires to be paid in full, such as family support obligations.

The Proposal would continue current law allowing a Chapter 13 plan to bifurcate claims secured by property other than residential real estate, but it would provide in addition that the holder of such a claim arising from a purchase made by the debtor within one year of the bank-

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ruptcy could require the debtor to surrender the collateral. This would remove any incentive for debtors to "load up" on secured debt shortly before a bankruptcy filing.

Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

Valuation. Under current § 506(a), the value of a secured claim, for purposes of the bifurcation discussed above is determined "in light of the purpose of the valuation and of the proposed disposition or use of such property." Section 327 of S. 256 would change this flexible approach to valuation so as require that, in cases of individual debtors in Chapter 7 and Chapter 13, valuation of secured claims would always be determined "on the replacement value of such property as of the date of filing the petition, without deduction for costs of sale or marketing." Secured claims must be valued in many different contexts in individual bankruptcy cases—from determining how much a Chapter 13 debtor must pay in installments to retain collateral throughout a plan, to how much a Chapter 7 debtor must pay in a lump sum to redeem collateral, to how much a creditor must reduce its claim when collateral is surrendered. The current law, allowing for accommodation of these different circumstances, should be retained.

Allocation of payments. Section 202 of S. 256 adds a new subsection (i) to § 524 of the Code, which provides that a mortgage holder (or other creditor) whose claim is treated by a Chapter 13 plan must credit payments received under the plan in the manner that the plan requires; so that allocating plan payments to prepetition debt or late charges (and then attempting to collect additional sums from the debtor after the plan concludes) would be a violation of the discharge injunction. However, the language of section 202 is confusing and may unduly limit the impact of the provision:

> The willful failure of a creditor to credit payments received under a plan confirmed under this title, unless the order confirming the plan is revoked, the plan is in default, or the creditor has not received payments required to be made under the plan in the manner required by the plan (including crediting the amounts required under the plan), shall constitute a violation of an injunction under subsection (a)(2) if the act of the creditor to collect and failure to credit payments in the manner required by the plan caused material injury to the debtor.

The following language would more clearly and generally require crediting of plan payments according to the plan:

> Unless the order confirming a plan under this title is revoked, or the case in which the plan was filed is dismissed, or payments are not transmitted to the creditor in the manner required by the plan, the failure of a creditor to credit payments made pursuant to the plan in the manner required by the plan, and any act of the creditor to collect payments inconsistent with the treatment of the creditor's claim under the plan, shall constitute a violation of an injunction under subsection (a)(2).

Preconfirmation adequate protection. Under current law, a Chapter 13 debtor is required to make full plan payments to the trustee prior to confirmation, but the trustee is directed not to distribute payments to creditors until the plan is confirmed. This situation makes it difficult for preconfirmation adequate protection payments to be made to secured creditors, and for preconfirmation lease payments to be made to lessors, whenever the Chapter 13 plan calls for these payments to be made by the trustee. Section 309(c) of S. 256 deals with the need for precon-

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firmation payments, by requiring the debtor to deduct adequate protection and lease payments from the amounts otherwise payable to the trustee prior to confirmation, and send the deducted funds directly to the creditor. This approach will cause confusion: debtors will be unsure of the amounts required to be sent to the trustee, questions will arise as to whether the payments required to be sent to creditors were in fact sent by the debtor, and confirmation will likely be delayed. These problems can be avoided by retaining the requirement that the debtor submit full preconfirmation plan payments to the trustee, while directing the trustee to make adequate protection and lease payments prior to confirmation.

10. Miscellaneous Chapter 13 matters

Recommendation

1) The minimum term of a Chapter 13 plan, in the absence of full payment, should be extended to five years only for (a) those debtors whose income exceeds 150% of the applicable state median, and (b) those debtors who have converted their cases to Chapter 13 from Chapter 7 after the filing a motion under § 707(b) [modifies S. 256, § 318].

2) A Chapter 13 debtor should be required to file post-petition tax returns and amended budgets only if ordered by the court, either on its own motion or on the motion of any party in interest, based on a likelihood that the debtor's income or expenses will materially change [modifies S. 256, § 315(b)].

3) Chapter 13 plans should be required to provide for all debt payments to be made by the Chapter 13 trustee [new, amends § 1326(c) of the Code].

Comment

Minimum plan term. Under current law, the minimum term for a Chapter 13 plan that does not pay all claims in full is three years. Section 318 of S. 256 would extend this term to five years for all debtors with income over the applicable state median. For many debtors with more than median income, there will remain a choice between filing under Chapter 7 and Chapter 13, and the five-year minimum plan term will be a significant incentive to choose Chapter 7, with its immediate discharge, rather than Chapter 13. The extended plan term should be reserved for those debtors who are most likely to be able to address their financial difficulties outside of bankruptcy (those earning more than 150% of the applicable median), and those whose Chapter 7 filings are subject to a finding of abuse under § 707(b). The latter provision would create an incentive for debtors with a potential ability to repay to file under Chapter 13 in the first instance.

Tax returns and budgets. Section 315(b) of S. 256 imposes on Chapter 13 debtors the obligation to file with the court, if requested by the court or any party in interest, copies of all post-petition tax returns and annual budgets for the duration of the debtor's case. The tax returns are to be subject to regulations that will allow creditor access to the filings while protecting the privacy of the debtors. This provision is likely to impose substantial administrative burdens on the courts, both in connection with maintaining files in a semi-restricted form, and in enforcing the debtors' obligations. It can be anticipated that many Chapter 13 debtors who are current in plan payments will fail to file requested tax returns or budgets, leading to enforcement motions that generate expense for all parties involved and for the court. Chapter 13 plans that would otherwise have successfully completed payments to creditors may fail because of the debtor's delay in responding to such motions. Rather than create an absolute right to the filing of post-petition

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tax returns and budgets, it would be preferable to require these filings only in cases where it appears likely that the debtor's financial condition will change materially (for example, debtors with a temporary medical condition, or temporarily depressed employment). In this way, the resources of the court and the parties can be devoted to enforcing disclosure requirements in cases where they are likely to be significant.

Plan payments through the trustee. In many Chapter 13 cases, the most effective way to ensure that the debtor completes the plan is by deducting plan payments from the debtor's wages, pursuant to § 1325(c) of the Code. If all of the payments required by the plan are deducted, the debtor is no longer tempted to divert resources that should be used for debt payment to current consumption. However, the effectiveness of a wage deduction is lost if the debtor is responsible for making certain debt payments under the plan. Since those payments cannot be deducted from the wages, the debtor may still choose not to make the debt payment.

Frequently, Chapter 13 plans provide that debtors, rather than Chapter 13 trustees, will make current mortgage payments, or other large debt payments, in order to avoid paying fees to the trustees, whose fees are based on a percentage of the payments that they make. *See* 28 U.S.C. § 586(e)(1)(B). It would benefit the Chapter 13 system if debtors were required to make all debt payments through the trustee. This would both allow for fully effective wage deduction orders and allow the trustees to reduce their overall percentage fee. Section 1326(c) of the Code now provides that the trustee shall make payments to creditors under the plan "[e]xcept as otherwise provided in the plan or in the order confirming the plan." The change recommended here would be effectuated by removing this exception.

11. Bankruptcy administrator

Recommendation

Give the bankruptcy administrators in North Carolina and Alabama the same rights, duties and obligations as U.S. trustees [modified S. 256 §§ 232, 405, 416, 439, 1104].

Comment

In North Carolina and Alabama, bankruptcy administrators perform the administrative functions that are performed in other jurisdictions by U.S. trustees. Certain provisions of S. 256 affecting bankruptcy administration, noted above, refer only to U.S. trustees. These provisions should be amended to apply to bankruptcy administrators as well.

12. Individual Chapter 11 debtors

Recommendation

Omit S. 256, § 321, which would impose Chapter 13-type requirements on individual debtors in Chapter 11.

Comment

Under S. 256, § 321, individuals in Chapter 11 are to be treated more like individuals in Chapter 13. Property of the estate would include postpetition earnings. If an unsecured creditor

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objects to confirmation, the debtor must pay all disposable income as defined in § 1325(b)(2) for five years, or pay the claim in full. The debtor does not receive a discharge until all payments have been made under the plan. A creditor may request modification of a plan at any time before completion of the plan. These proposed changes, which apply to all individuals in Chapter 11 cases, are substantial changes that have not been exposed to public debate.

The provisions are based on Chapter 13 provisions that do not fit well with Chapter 11 concepts. In Chapter 13 an unsecured creditor can insist that a debtor commit all disposable income to a plan for three years. That makes sense in Chapter 13 where creditors do not vote. But in Chapter 11 creditors do vote, and a single creditor should not be able to defeat a plan by objecting. Also, a single creditor could request modification of a plan. The ramifications of delaying a discharge in a Chapter 11 case have not been sufficiently studied.

All of these proposed changes should be omitted until they have been studied and exposed to public debate. If the Chapter 13-type requirements are included at all, they should be placed in § 1129(b).

13. Small business provisions

Recommendation

1) Change the definition of small business debtor to be consistent with present § 101(51C) of the Bankruptcy Code [retains the $2 million aggregate debt limit of S. 256, § 432, but eliminates unworkable provisions of the definition].

2) Permit flexibility with respect to disclosure statements [same as S. 256, §§ 431, 433].

3) Permit conditional approval of disclosure statements [same as S. 256, § 431].

4) Permit combined disclosure statement and confirmation hearings [same as S. 256, § 431].

5) Establish uniform reporting requirements for small businesses, with uniform forms proposed by the Advisory Committee on Bankruptcy Rules [same as S. 256, §§ 434 and 435].

6) Provide that the debtor must file (rather than "append") a balance sheet and statement of operations together with its petition; delete tax returns from the filing requirement [modifies S. 256, § 436].

7) Require status conferences "necessary to further the expeditious and economical resolution of the case"; change section title to "status conference" [modifies S. 256, § 440 only to make its title consistent with the substantive provision].

8) Retain the 120-day exclusivity period for plan filing by the debtor [modifies the 180-day period of S. 256, § 437].

9) Require the debtor to file a plan and disclosure statement within 120 days of the order for relief, with extensions for cause possible up to 300 days after the order for relief; allow further extensions of the filing deadline only upon a showing by the debtor of extraordi-

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00177 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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nary circumstances and a strong likelihood that a confirmable plan will be proposed within the further extension [modifies S. 256, § 437].

10) Omit the requirement that a plan be confirmed within 45 days of filing [modifies S. 256, § 438].

11) Require termination of the automatic stay in defined situations of repeat filings, as set out in Recommendation 5 [consistent with S. 256, § 441(2) except that an order on motion is required].

12) Conduct a study to determine why small businesses become debtors and the best way for these small businesses to reorganize [same as S. 256, § 443].

Comment

Under current law, special, optional treatment is provided under Chapter 11 for a "small business." S. 256 alters the definition of small business and makes the special treatment mandatory. As a whole, the changes are helpful, but several present difficulties.

Definition. Consistent with current law, § 432 of S. 256 defines a "small business debtor" as a business with not more than $2 million in aggregate debt, but then adds qualifications (1) that affiliates of the debtor, also involved in bankruptcy proceedings, are to be included with the debtor in calculating the amount of debt, and (2) that cases in which the U.S. trustee has appointed a creditor's committee are excluded from the definition unless the court determines that the committee is "not sufficiently active and representative to provide effective oversight of the debtor." The $2 million limit properly includes most Chapter 11 debtors; however, the language regarding affiliates of the debtor is awkward and may exclude affiliated entities that are truly separate businesses from being small business debtors. Also, the presence of an active creditor's committee should not preclude small business treatment (and, in any event, there would be considerable uncertainty as to whether the small business provisions applied, since the court could make a determination that a committee was insufficiently active at any time). The references to affiliates and to committees should be eliminated, retaining the substance of the current definition of small business.

Flexible disclosure statement requirements. S. 256, § 431 amends Bankruptcy Code § 1125(a)(1) to list factors that the court should consider when approving a disclosure statement and amends Bankruptcy Code § 1125(f) to give the court, in small business cases, the flexibility to dispense with a disclosure statement and to approve form disclosure statements. Both amendments improve the operation of Chapter 11 in small business cases.

Conditional approval of disclosure statement; combined hearing on disclosure statement and confirmation. S. 256, § 431 amends § 1125 of the Bankruptcy Code to give the court in small business cases the flexibility (1) to approve disclosure statements conditionally and (2) to combine the hearing on adequacy of the disclosure statement with the confirmation hearing. For many years, a number of bankruptcy courts have successfully utilized these practices, and the Code is improved by express statutory provision allowing it.

Uniform reporting requirements; reporting rules and forms. S. 256, § 434 requires small business debtors to file specific reports, to match projections with actual cash disbursements, to certify compliance with their reports and with the Federal Rules of Bankruptcy Procedure, and to explain how noncompliance will be cured. S. 256, § 435 directs the Advisory Committee on

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00178 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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Bankruptcy Rules to propose rules and forms and provides that the reporting requirements shall take effect 60 days after the rules are prescribed. These reports are already required in most jurisdictions by U.S. trustees or bankruptcy administrators. Some of the terms used in S. 256 are somewhat vague (e.g., "such other matters as are in the best interest of the debtor and creditors"), but these requirements can be made specific through the Rules process.

Duties of the small business debtor. S. 256, § 436 requires small business debtors to "append" to their bankruptcy petitions their most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return. In addition, it requires senior management to attend meetings, scheduling conferences, and meetings of creditors unless the court, upon a finding of extraordinary and compelling circumstances, waives attendance. It requires that debtors timely file all schedules (subject to a maximum extension of 30 days absent extraordinary and compelling circumstances), maintain customary insurance, timely file tax returns, and pay current taxes. Most courts already impose most of these duties and require these documents, and making these requirements uniform is good policy. However, he term "append" is not applicable to electronic filing and should be replaced with "file," and tax returns should be excepted from the filing requirement, since they will often not be appropriately made part of the public record.

Duties of the U.S. trustee. S. 256, § 439 expands the duties of the U.S. trustee in small business cases to include conducting an initial interview, investigating viability, asking about the debtor's plan, developing a scheduling order, verifying the filing of tax returns, and monitoring activities to ascertain inability to confirm a plan. If the trustee finds material grounds for relief under § 1112, the trustee shall apply promptly after making that finding to the court for relief. U.S. trustees and bankruptcy administrators are already performing many of these functions. It should be noted that the provision requiring the U.S. trustee to move for dismissal or conversion applies to all Chapter 11 cases, not just to small business cases.

Scheduling conferences. S. 256, § 440 amends § 105(d) of the Bankruptcy Code to make status conferences mandatory, providing that the court "shall hold such status conferences as are necessary to further the expeditious and economical resolution of the case." This provision applies to all Chapter 11 cases. Many courts now hold status conferences. There are no guidelines as to who should attend, but this would be left to the Bankruptcy Rules. Courts should have flexibility in designing the type of status conference that works best in the district and in the particular case. The title of this Conference Report section is "Scheduling Conferences" and should be changed to "Status Conferences."

Exclusivity in small business cases. S. 256, § 437 provides that in a small business case the debtor has the exclusive right to file a plan for 180 days after the order for relief, unless the time is extended or reduced for cause. Obtaining an extension of the 180-day period is appropriately difficult, with the debtor required to "demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time." Furthermore, in situations where exclusivity is to be extended, a new deadline must be imposed, and the order must be signed before expiration of the first deadline. Presently all Chapter 11 debtors have a 120-day period of exclusivity that may be extended "for cause." Small business cases should move quickly, and the exclusivity period should not be longer than in regular Chapter 11 cases. However, requiring an extension order to be signed prior to the expiration of the deadline penalizes a debtor for delays caused by a court. The period of exclusivity should remain at 120 days, and the requirement that the order must be signed prior to expiration of the deadline should be omitted.

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00179 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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Deadline for plan filing. S. 256, § 437 provides that a small business debtor must file a plan not later than 300 days after the order for relief. There is no provision for reducing the 300-day period and it may only be extended in the same manner as extending the 180-day period of exclusivity. In most small business chapter 11 cases a plan should be filed well before 300 days. If 300 days is the limit, it may become the standard. The limit should be 120 days with extensions for "cause" up to a 300-day maximum. In order for an extension beyond 300 days to be granted, the debtor would be required to "demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time."

Confirmation deadline. S. 256, § 438 provides that the plan in a small business Chapter 11 case must be confirmed within 45 days after the plan is filed with the court, unless that deadline is extended after a hearing in which the debtor shows that a plan is likely to be confirmed thereafter. This provision is intended to reduce the delay and costs involved in confirming Chapter 11 plans, but would actually have the effect of requiring the extension hearing in nearly every case, and so increase expense. The Bankruptcy Rules require 25 days notice for a disclosure statement hearing (Fed. R. Bankr. P. 3017(a)) and 25 days notice for a confirmation hearing (Fed. R. Bankr. P. 3017(b)). Combining the two hearings is discretionary, and if the two hearings were not combined it would be impossible to meet the 45-day limit. Even in districts where the hearings are routinely combined, like the Eastern District of North Carolina, the combined hearings are normally held approximately 50 days after the plan is filed.

The Proposal would extend the deadline for confirmation of small business Chapter 11 cases to 60 days. Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

Small business serial filers. See Recommendation 5, above.

Small business study. S. 256, § 443 provides that the Small Business Administration is to conduct a 2-year study to learn why small businesses become debtors and the best way for these small businesses to reorganize. This is an excellent idea.

14. Expanded grounds for dismissal

Proposal

1) Give the court discretion with respect to dismissal in Bankruptcy Code § 1112, by retaining the "may" dismiss in the Code and omitting the "shall" dismiss in S. 256 [modifies S. 256, § 442].

2) Expand the "for cause" list in Bankruptcy Code § 1112 [same as S. 256, § 442].

3) Omit the 30-day time limit for commencing a hearing on a motion to dismiss and omit the 15-day limit on deciding such a motion [modifies S. 256, § 442].

Comment

S. 256, § 442 amends § 1112 of the Bankruptcy Code to provide that the court "shall" dismiss or convert a Chapter 11 case for cause unless (1) there are "unusual circumstances specifically identified by the court" that establish that such relief is not in the best interests of creditors and the estate, or (2) the debtor or another party in interest objects and shows that (a) there is

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00180 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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a reasonable likelihood of plan confirmation within the applicable deadline and (b) that there was reasonable justification for any act of the debtor that provided cause for relief and that the act will be cured within a reasonable time. "Cause" is appropriately defined as including gross mismanagement, failure to maintain insurance, unauthorized use of cash collateral, failure to file a report, failure to appear for examination, failure to pay taxes or file tax returns, failure to file a plan on time, failure to effectuate substantial consummation of a plan, material default under a plan and failure to pay domestic support obligations. As an alternative to conversion or dismissal, the court would be able to appoint a trustee or examiner.

Like the confirmation deadline, these provisions are intended to reduce the cost involved in administering Chapter 11 cases. However, particularly since these provisions apply to Chapter 11 cases of all sizes, they are likely to increase the cost of administration by requiring substantially longer, confirmation-like hearings whenever dismissal or conversion is contested, with the court needing to resolve factual and legal questions about the presence of unusual circumstances, the likelihood of timely confirmation, and the possibility of curing an untimely filing. Moreover, the 30-day time period for holding a hearing and the 15-day time limit for deciding the issue are too restrictive.

The Proposal would give the court discretion to convert or dismiss in consideration of the factors set out in § 442 without mandating dismissal in the absence of specified findings, and would omit the hearing and ruling deadlines.

Draft statutory language effectuating this recommendation is included in an appendix to the Proposal.

15. Requirement to describe tax consequences

Proposal

> Omit the requirement in S. 256, § 717 that Chapter 11 debtors include in the disclosure statement a description of the tax consequences of the plan [modifies S. 256, § 717].

Comment

S. 256, § 717 amends § 1125(a)(1) of the Bankruptcy Code to require that a disclosure statement include "a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case." This requirement is not realistic. A debtor will not know the tax consequences to its creditors, and any tax opinion would be costly and speculative at best.

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Table of Proposed Revisions to S. 256

Sec. No.	Issue	Present Content	Proposed Treatment
101	Consent to conversion in 707(b)	Allows consensual conversion to Ch. 12 or 13 as an alternative to dismissal	Retain
102	Means testing	Complex presumption of abuse based on IRS collection standards; enhanced scheduling and noticing requirements for all debtors; enhanced liability for debtors' counsel	Amend: Means test based on gross income; safe harbor under median; creditor standing to file § 707(b) motions above median; enhanced scrutiny above defined level (150% of median); omit enhanced attorney liability
103	IRS standards amendment and study	Sense of Congress that standards may be altered; EOUST study ordered	Retain study; omit sense of Congress pending study on use of IRS standards
105	Pilot educational program	18-month test of educational programs in six districts, followed by report of Director of EOUST to Congress	Retain
106	credit counseling; mandatory debtor education	credit counseling an eligibility requirement, education required for all consumer debtors.	Amend to make credit counseling required only in chapter 7; defer mandatory education pending results of pilot program
107	Schedules for Chapter 13 expenses	Part of the formula for calculating means-test deductions	Omit pending results of study on use of IRS standards
202	Failure to credit plan payments; ride-through contacts for home mortgages	Some failures to credit plan payments made a violation of discharge injunction; request for payment in lieu of foreclosure not a violation	Amend to clarify provision regarding failure to credit plan payments
203	Reaffirmation	Extensive disclosure requirement with broad safe harbors for creditors);	Omit subject to completion of study
302	Stay exceptions for serial filings	30-day termination of stay in first refiling within a year; no stay in second refiling unless required showings made	Amend to provide for order terminating stay
304	Stay for personal property collateral	Stay terminated if no redemption or reaffirmation in 45 days after first meeting; no installment redemption	Amend to provide for order terminating stay
305	Stay for personal property and leases	Similar to 304 of the Act, as above, but with conflicting terms	Amend to add leases to procedure under § 304
306	Secured debt in Chapter 13	(1) Requires lien retention until debt paid in full or discharge granted; (2) 2-1/2 year anti-stripdown for car loans; (3) 1 year anti-stripdown for all other secured debt; (4) principal residence defined.	Amend to provide that a creditor with a pmsi not more than one year old may require return of collateral
309	Chapter 13 secured claims	(1) secured claim not reduced on conversion to Ch 7; (2) procedures for debtors to assume personal property leases; (3) adequate protection payments, including preconfirmation payments directly by the debtor; (4) proof of insurance required from debtor	Amend to provide for preconfirmation adequate protection payments to be made by the Chapter 13 trustee from payments made to the trustee by the debtor
312	Extended time between discharges	727(a) extended to 8 years; no discharge in 13 if prior discharge in a 7, 11, or 12 filed within 4 years or a 13 filed within 2 years	Amend to retain current law regarding Chapter 13 discharge

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00182 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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314	New ground for nondischargeability; superdischarge	(a) Debts incurred to pay non-federal taxes excepted from discharge; (b) superdischarge eliminated for 523(a)(2) and (4) and for personal injuries	Amend to create new ground for credit card nondischargeability, subject to Chapter 13 superdischarge
315	Notice to creditors	(a) Complex notice system with burden on debtor to show effective notice; (b) new document production requirements for debtors, including pay stubs, tax returns, and annual budgets	Omit notice provisions pending adoption of electronic filing procedures; provide for wage information to be provided to trustee prior to creditors meeting
316	Automatic dismissal for inadequate filings	Failure to file results in dismissal without motion, deadline only extended once	Amend to require entry of order on motion; allow trustee objection for avoidance actions or 727 action
318	Term of Chapter 13 plan	5 yrs for debtors over the median income level	Amend: 5 years for debtors with income more than 150% of median or who pursue Chapter 13 after a 707(b) motion
321	Individual Chapter 11 cases	Generally imposes Chapter 13 rules	Omit
327	§ 506(a) valuation	Requires retail value in Ch 7/13 individual cases	Omit
431	Flexible Rules for disclosure statement and plan	List of factors when considering disclosure statement; flexibility in approving disclosure statement; approval of form disclosure statements; conditional approval of disclosure statements; combining hearings on disclosure statement and confirmation of plan	Retain
432	Definition	$2 million in aggregate debt (includes debtor affiliates but excludes debtor affiliates with more than $2 million in debt) where creditors' committee has not been appointed or committee is not sufficiently active	Omit references to affiliates and committees; keep present definition in § 101(51C)
433	Standard form disclosure statement and plan	Bankruptcy Rules Committee to propose standard forms for disclosure statements and plans	Retain
434	Uniform reporting requirements	Small business debtors must file reports and certify compliance with reports and Bankruptcy Rules	Retain
435	Uniform rules and forms	Bankruptcy Rules Committee to propose forms for reports	Retain
436	Debtor duties in small business cases	Small business debtors must "append" most recent balance sheet, statement of operations, cash flow, and income tax statement to petition; senior management must attend meetings and conferences; must file schedules on time, maintain insurance. file tax returns and pay current taxes	Retain most provisions; delete "append;" do not make income tax return part of public record; delete "extraordinary and compelling circumstances" standard

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00183 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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437	Plan filing and confirmation deadlines	Small business debtor has 180-day period of exclusivity; debtor must file a plan not later than 300 days after the order for relief; deadlines may not be extended unless debtor can demonstrate by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time	Amend to provide 120-day exclusivity period, extendable for cause; small business debtor must file plan within 90 days of order for relief, but time may be extended for cause; court may not extend time beyond 300 days unless the debtor makes specified showing
438	Plan confirmation deadline	Court shall confirm a plan not later than 45 days after it is filed	Omit
439	UST duties	Expands duties of UST in small business cases, including verifying filing of tax returns	Retain
440	Scheduling conference	Court shall hold such status conferences as are necessary to further the expeditious and economical resolution of the case	Retain, except change caption to "Status Conferences"
441	Serial filer provisions	Automatic stay does not apply with respect to certain serial filing small business debtors	Retain, except require order terminating the stay on motion
442	Expanded grounds for dismissal or conversion	Court "shall" convert or dismiss "absent unusual circumstances" upon showing of cause; cause is defined	Modify to give court more discretion as to whether to convert or dismiss
443	Small business study	Small Business Administration to study causes of small business filings and to determine best way for small business debtors to reorganize	Retain
603	Audits	Audits must be conducted of a random minimum 0.4% of all consumer filings and of all schedules "reflecting greater than average variance" from district norms, under GAAS by independent certified or licensed public accountants or under regulations of the Attorney General (adopted within 2 years of enactment of the legislation); 18 month delay in effect	Amend: audits charged only to those in "enhanced scrutiny" class; all audits should be conducted pursuant to EOUST regulations, by employees or contractors of EOUST; regulations within 18 months; effective 6 months thereafter
707	Superdischarge	523(a)(1)(B) (unfilled or late filed taxes) and (C) (fraudulently filed taxes) made nondischargeable in Ch 13	Amend: remove only § 523(a)(1)(C) tax debts from the superdischarge of § 1328(a)

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00184 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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Draft Statutory Language for Selected Recommendations Modifying S. 256

Recommendation 1

SEC. 102. DISMISSAL OR CONVERSION.

(a) **IN GENERAL**- Section 707 of title 11, United States Code, is amended--

(1) by striking the section heading and inserting the following: "Sec. 707. Dismissal of a case or conversion to a case under chapter 11 or 13";

and

(2) in subsection (b)--

(A) by inserting "(1)" after "(b)";

(B) in paragraph (1), as so redesignated by subparagraph (A) of this paragraph--

(i) in the first sentence--

(I) by striking "but not at the request or suggestion of" and inserting "trustee (or bankruptcy administrator, if any), or";

(II) by striking "whose debts are primarily consumer debts":

(III) by inserting ", or, with the debtor's consent, convert such a case to a case under chapter 11 or 13 of this title," after "consumer debts"; and

(IV) by striking "a substantial abuse" and inserting "an abuse"; and

(ii) by striking the next to last sentence; and

(C) by adding at the end the following:

"(2)(A)In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter, the court shall presume abuse exists if the debtor's projected annual disposable income exceeds $1800. '

"(B) For the purposes of this paragraph, 'disposable income' shall have the meaning set out in section 1325(b) of this title, except that 'disposable income' shall not include'''''''', for a debtor eligible for chapter 13, the expenses that the debtor would incur in' administering a chapter 13 plan for the district in which the debtor resides, up to an amount of 10 percent of the projected plan payments, as determined under schedules issued by the Executive Office for United States Trustees.''''''''

"(C) As part of the schedule of current income and expenditures required under section 521, the debtor shall include a statement of the debtor's projected annual disposable income showing how this amount was calculated.

"(3) In considering under paragraph (1) whether the granting of relief would be an abuse of the

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provisions of this chapter in a case in which the presumption in subparagraph (A)(i) of such paragraph does not arise or is rebutted, the court shall consider--

"(A) whether the debtor filed the petition in bad faith; or

"(B) the totality of the circumstances (including the extent of the exemptions claimed by the debtor and whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor's financial situation demonstrates abuse.

"(4)(A) The court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described in rule 9011 of the Federal Rules of Bankruptcy Procedure, may order the attorney for the debtor to reimburse the trustee for all reasonable costs in prosecuting a motion filed under section 707(b), including reasonable attorneys" fees, if--

"(i) a trustee files a motion for dismissal or conversion under this subsection; and

"(ii) the court--

"(I) grants such motion; and

"(II) finds that the action of the attorney for the debtor in filing under this chapter violated rule 9011 of the Federal Rules of Bankruptcy Procedure.

"(B) If the court finds that the attorney for the debtor violated rule 9011 of the Federal Rules of Bankruptcy Procedure, the court, on its own initiative or on the motion of a party in interest, in accordance with such procedures, may order--

"(i) the assessment of an appropriate civil penalty against the attorney for the debtor; and

"(ii) the payment of such civil penalty to the trustee, the United States trustee (or the bankruptcy administrator, if any).

"(C) The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has--

"(i) performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and

"(ii) determined that the petition, pleading, or written motion--

"(I) is well grounded in fact; and

"(II) is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1).

"(D) The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.

"(5)(A) Except as provided in subparagraph (B) and subject to paragraph (6), the court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described

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in rule 9011 of the Federal Rules of Bankruptcy Procedure, may award a debtor all reasonable costs (including reasonable attorneys" fees) in contesting a motion filed by a party in interest (other than a trustee or United States trustee (or bankruptcy administrator, if any)) under this subsection if--

"(i) the court does not grant the motion; and

"(ii) the court finds that--

"(I) the position of the party that filed the motion violated rule 9011 of the Federal Rules of Bankruptcy Procedure; or

"(II) the attorney (if any) who filed the motion did not comply with the requirements of clauses (i) and (ii) of paragraph (4)(C), and the motion was made solely for the purpose of coercing a debtor into waiving a right guaranteed to the debtor under this title.

"(B) A small business that has a claim of an aggregate amount less than $1,000 shall not be subject to subparagraph (A)(ii)(I).

"(C) For purposes of this paragraph--

"(i) the term "small business" means an unincorporated business, partnership, corporation, association, or organization that--

"(I) has fewer than 25 full-time employees as determined on the date on which the motion is filed; and

"(II) is engaged in commercial or business activity; and

"(ii) the number of employees of a wholly owned subsidiary of a corporation includes the employees of--

"(I) a parent corporation; and

"(II) any other subsidiary corporation of the parent corporation.

"(6) Only the judge or United States trustee (or bankruptcy administrator, if any) may file a motion under section 707(b), if the debtor, or in a joint case, the debtor and the debtor's spouse, had adjusted gross income in the tax year preceding the filing of the case, and will have projected adjusted gross income in the tax year in which the case is filed, equal to or less than--

"(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

"(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

"(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4.

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00187 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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"(7)(A) No judge, United States trustee (or bankruptcy administrator, if any), trustee, or other party in interest may file a motion under paragraph (2) if the debtor and the debtor's spouse combined, had adjusted gross income in the tax year preceding the filing of the case, and will have projected adjusted gross income in the tax year in which the case is filed, equal to or less than--

"(i) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

"(ii) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

"(iii) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4.

"(B) In a case that is not a joint case, current monthly income of the debtor's spouse shall not be considered for purposes of subparagraph (A) if--

"(i)(I) the debtor and the debtor's spouse are separated under applicable nonbankruptcy law; or

"(II) the debtor and the debtor's spouse are living separate and apart, other than for the purpose of evading subparagraph (A); and

"(ii) the debtor files a statement under penalty of perjury--

"(I) specifying that the debtor meets the requirement of subclause (I) or (II) of clause (i); and

"(II) disclosing the aggregate, or best estimate of the aggregate, amount of any cash or money payments received annually from the debtor's spouse'.".

''''

(b) **UNITED STATES TRUSTEE AND BANKRUPTCY ADMINISTRATOR DUTIES. --** Section 704 of title 11, United States Code, is amended--

(1) by inserting "(a)" before "The trustee shall--"; and

(2) by adding at the end the following:

"(b)(1) With respect to a debtor who is an individual in a case under this chapter--

"(A) the United States trustee (or the bankruptcy administrator, if any) shall review all materials filed by the debtor and, not later than 10 days after the date of the first meeting of creditors, file with the court a statement as to whether the debtor's case would be presumed to be an abuse under section 707(b); and

"(B) not later than 5 days after receiving a statement under subparagraph (A), the court shall provide a copy of the statement to all creditors.

"(2) The United States trustee (or bankruptcy administrator, if any) shall, not later than 30 days after the date of filing a statement under paragraph (1), either file a motion to dismiss or convert under section 707(b) or file a statement setting forth the reasons the United States trustee (or the

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bankruptcy administrator, if any) does not consider such a motion to be appropriate, if the United States trustee (or the bankruptcy administrator, if any) determines that the debtor's case should be presumed to be an abuse under section 707(b) and the product of the debtor's current monthly income, multiplied by 12 is not less than--

"(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner; or

"(B) in the case of a debtor in a household of 2 or more individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals.".

(c) **NOTICE**.-- Section 342 of title 11, United States Code, is amended by adding at the end the following:

"(d) In a case under chapter 7 of this title in which the debtor is an individual and in which the presumption of abuse arises under section 707(b), the clerk shall give written notice to all creditors not later than 10 days after the date of the filing of the petition that the presumption of abuse has arisen.".

(d) **NONLIMITATION OF INFORMATION**.--Nothing in this title shall limit the ability of a creditor to provide information to a judge (except for information communicated ex parte, unless otherwise permitted by applicable law), United States trustee (or bankruptcy administrator, if any), or trustee.

(e) **DISMISSAL FOR CERTAIN CRIMES**.--Section 707 of title 11, United States Code, is amended by adding at the end the following:

"(c)(1) In this subsection--

"(A) the term 'crime of violence' has the meaning given such term in section 16 of title 18; and

"(B) the term 'drug trafficking crime' has the meaning given such term in section 924(c)(2) of title 18.

"(2) Except as provided in paragraph (3), after notice and a hearing, the court, on a motion by the victim of a crime of violence or a drug trafficking crime, may when it is in the best interest of the victim dismiss a voluntary case filed under this chapter by a debtor who is an individual if such individual was convicted of such crime.

"(3) The court may not dismiss a case under paragraph (2) if the debtor establishes by a preponderance of the evidence that the filing of a case under this chapter is necessary to satisfy a claim for a domestic support obligation.".

(f) **CONFIRMATION OF PLAN**.--Section 1325(a) of title 11, United States Code, is amended--

(1) in paragraph (5), by striking "and" at the end;

(2) in paragraph (6), by striking the period and inserting a semicolon; and

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(3) by inserting after paragraph (6) the following:

"(7) the action of the debtor in filing the petition was in good faith;".

'''

(g) **ADJUSTMENT OF DOLLAR AMOUNTS**.--Section 104(b) of title 11, United States Code, is amended by striking "and 523(a)(2)(C)" each place it appears and inserting "523(a)(2)(C), and 707(b)".

(h) **DEFINITION OF 'MEDIAN FAMILY INCOME'**.--Section 101 of title 11, United States Code, is amended by inserting after paragraph (39) the following:

"(39A) 'median family income' means for any year--

"(A) the median family income both calculated and reported by the Bureau of the Census in the then most recent year; and

"(B) if not so calculated and reported in the then current year, adjusted annually after such most recent year until the next year in which median family income is both calculated and reported by the Bureau of the Census, to reflect the percentage change in the Consumer Price Index for All Urban Consumers during the period of years occurring after such most recent year and before such current year;".

(i) **CLERICAL AMENDMENT**.--The table of sections for chapter 7 of title 11, United States Code, is amended by striking the item relating to section 707 and inserting the following:

"707..Dismissal of a case or conversion to a case under chapter 11 or 13.".

SEC. 103. SENSE OF CONGRESS AND STUDY.

(a) **SENSE OF CONGRESS**.--It is the sense of Congress that the Secretary of the Treasury has the authority to alter the Internal Revenue Service standards established to set guidelines for repayment plans as needed to accommodate their use under section 707(b) of title 11, United States Code.

(b) **STUDY**.--

(1) **IN GENERAL**.--Not later than 2 years after the date of enactment of this Act, the Director of the Executive Office for United States Trustees shall submit a report to the Committee on the Judiciary of the Senate and the Committee on the Judiciary of the House of Representatives containing the findings of the Director regarding the utilization of Internal Revenue Service standards for determining--

(A) the current monthly expenses of a debtor under section 707(b) of title 11, United States Code; and

(B) the impact that the application of such standards would haveon debtors and on the bankruptcy courts.

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00190 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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(2) **RECOMMENDATION**.--The report under paragraph (1) may include recommendations for amendments to title 11, United States Code, that are consistent with the findings of the Director under paragraph (1).

Recommendation 3

SEC. 106. CREDIT COUNSELING.

(a) **WHO MAY BE A DEBTOR**.--Section 109 of title 11, United States Code, is amended by adding at the end the following:

"(h)(1) Subject to paragraphs (2) and (3), and notwithstanding any other provision of this section, an individual may not be a debtor under chapter 7 of this title unless such individual has, during the 180-day period preceding the date of filing of the petition by such individual, received from an approved nonprofit budget and credit counseling agency described in section 111(a) an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.

"(2)(A) Paragraph (1) shall not apply with respect to a debtor who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the approved nonprofit budget and credit counseling agencies for such district are not reasonably able to provide adequate services to the additional individuals who would otherwise seek credit counseling from such agencies by reason of the requirements of paragraph (1).

"(B) The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in subparagraph (A) shall review such determination not later than 1 year after the date of such determination, and not less frequently than annually thereafter. Notwithstanding the preceding sentence, a nonprofit budget and credit counseling agency may be disapproved by the United States trustee (or the bankruptcy administrator, if any) at any time.

"(3)(A) Subject to subparagraph (B), the requirements of paragraph (1) shall not apply with respect to a debtor who submits to the court a certification that--

"(i) describes exigent circumstances that merit a waiver of the requirements of paragraph (1);

"(ii) states that the debtor requested credit counseling services from an approved nonprofit budget and credit counseling agency, but was unable to obtain the services referred to in paragraph (1) during the 5-day period beginning on the date on which the debtor made that request; and

"(iii) is satisfactory to the court.

"(B) With respect to a debtor, an exemption under subparagraph (A) shall cease to apply to that debtor on the date on which the debtor meets the requirements of paragraph

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00191 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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(1), but in no case may the exemption apply to that debtor after the date that is 30 days after the debtor files a petition, except that the court, for cause, may order an additional 15 days.".

(b) **CHAPTER** 7 **DISCHARGE**.--Section 727(a) of title 11, United States Code, is amended--

(1) in paragraph (9), by striking "or" at the end;

(2) in paragraph (10), by striking the period and inserting "; or"; and

(3) by adding at the end the following:

"(11) after filing the petition, the debtor failed to complete an instructional course concerning personal financial management described in section 111, except that this paragraph shall not apply with respect to a debtor who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the approved instructional courses are not adequate to service the additional individuals who would otherwise be required to complete such instructional courses under this section (The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in this paragraph shall review such determination not later than 1 year after the date of such determination, and not less frequently than annually thereafter.).".

(c) **CHAPTER** 13 **DISCHARGE**.--Section 1328 of title 11, United States Code, is amended by adding at the end the following:

"(g)(1) The court shall not grant a discharge under this section to a debtor unless after filing a petition the debtor has completed an instructional course concerning personal financial management described in section 111.

"(2) Paragraph (1) shall not apply with respect to a debtor who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the approved instructional courses are not adequate to service the additional individuals who would otherwise be required to complete such instructional course by reason of the requirements of paragraph (1).

"(3) The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in paragraph (2) shall review such determination not later than 1 year after the date of such determination, and not less frequently than annually thereafter.".

(d) **DEBTOR'S DUTIES**.--Section 521 of title 11, United States Code, is amended--

(1) by inserting "(a)" before "The debtor shall--"; and

(2) by adding at the end the following:

"(b) In addition to the requirements under subsection (a), an individual debtor in a chapter 7 case shall file with the court--

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"(1) a certificate from the approved nonprofit budget and credit counseling agency that provided the debtor services under section 109(h) describing the services provided to the debtor; and

"(2) a copy of the debt repayment plan, if any, developed under section 109(h) through the approved nonprofit budget and credit counseling agency referred to in paragraph (1).".

[Note: The remainder of § 106 of S. 256 is not affected by the recommendation.]

Recommendation 6

SEC. 315. GIVING CREDITORS FAIR NOTICE IN CHAPTERS 7 AND 13 CASES.

(a) **STUDY**.--

(1) **IN GENERAL**.--Not later than 2 years after the date of enactment of this Act, the Director of the Administrative Office of the United States Courts shall submit a report to the Committee on the Judiciary of the Senate and the Committee on the Judiciary of the House of Representatives containing the findings of the Director regarding the utilization of electronic notice to creditors in cases filed under title 11, United States Code.

(2) **RECOMMENDATION**.--The report under paragraph (1) may include recommendations for amendments to title 11, United States Code, that are consistent with the findings of the Director under paragraph (1).

[Note: The remainder of § 315 of S. 256 is not affected by the recommendation.]

Recommendation 9

SEC. 306. GIVING SECURED CREDITORS FAIR TREATMENT IN CHAPTER 13.

(a) **IN GENERAL**.--Section 1325(a)(5)(B)(i) of title 11, United States Code, is amended to read as follows:

"(i) the plan provides that--

"(I) the holder of such claim retain the lien securing such claim until the earlier of--

"(aa) the payment of the underlying debt determined under nonbankruptcy law; or

"(bb) discharge under section 1328; and

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"(II) if the case under this chapter is dismissed or converted without completion of the plan, such lien shall also be retained by such holder to the extent recognized by applicable nonbankruptcy law; and".

(b) **RESTORING THE FOUNDATION FOR SECURED CREDIT**.--Section 1325 of title 11, United States Code, is amended by adding at the end the following:

"(d) Section 362(a) of this title shall not apply, pending confirmation of a plan under this section, to a claim if the creditor has a purchase money security interest securing the debt that is the subject of the claim and the debt was incurred during the 1-year period preceding the filing of the petition.".

(c) **DEFINITIONS**.--Section 101 of title 11, United States Code, is amended--

(1) by inserting after paragraph (13) the following:

"(13A) 'debtor's principal residence'--

"(A) means a residential structure, including incidental property, without regard to whether that structure is attached to real property; and

"(B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer;"; and

(2) by inserting after paragraph (27), the following:

"(27A) 'incidental property' means, with respect to a debtor's principal residence--

"(A) property commonly conveyed with a principal residence in the area where the real property is located;

"(B) all easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil or gas rights or profits, water rights, escrow funds, or insurance proceeds; and

"(C) all replacements or additions;".

Recommendation 13

SEC. 438. PLAN CONFIRMATION DEADLINE.

Section 1129 of title 11, United States Code, is amended by adding at the end the following:

"(e) In a small business case, the court shall confirm a plan that complies with the applicable provisions of this title and that is filed in accordance with section 1121(e) not later than 60 days after the plan is filed unless the time for confirmation is extended in accordance with section 1121(e)(3).".

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Recommendation 14

SEC. 442. EXPANDED GROUNDS FOR DISMISSAL OR CONVERSION AND APPOINTMENT OF TRUSTEE.

(a) **EXPANDED GROUNDS FOR DISMISSAL OR CONVERSION.**--Section 1112 of title 11, United States Code, is amended by striking subsection (b) and inserting the following:

"(b)(1) Except as provided in subsection (c) of this section and section 1104(a)(3), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter if the movant establishes cause to believe that conversion or dismissal would be in the best interests of creditors and estate.

"(2) For purposes of this subsection, the term 'cause' includes--

"(A) substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;

"(B) gross mismanagement of the estate;

"(C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;

"(D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;

"(E) failure to comply with an order of the court;

"(F) unexcused failure to satisfy timely any filing or reporting requirement established by this title or by any rule applicable to a case under this chapter;

"(G) failure to attend the meeting of creditors convened under section 341(a) or an examination ordered under rule 2004 of the Federal Rules of Bankruptcy Procedure without good cause shown by the debtor;

"(H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);

"(I) failure timely to pay taxes owed after the date of the order for relief or to file tax returns due after the date of the order for relief;

"(J) failure to file a disclosure statement, or to file or confirm a plan, within the time fixed by this title or by order of the court;

"(K) failure to pay any fees or charges required under chapter 123 of title 28;

"(L) revocation of an order of confirmation under section 1144;

"(M) inability to effectuate substantial consummation of a confirmed plan;

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"(N) material default by the debtor with respect to a confirmed plan;

"(O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and

"(P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.".

(b) **ADDITIONAL GROUNDS FOR APPOINTMENT OF TRUSTEE**.--Section 1104(a) of title 11, United States Code, is amended--

(1) in paragraph (1), by striking "or" at the end;

(2) in paragraph (2), by striking the period at the end and inserting "; or"; and

(3) by adding at the end the following:

"(3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.".

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WINSTEAD

February 4, 2005

direct dial: 512-370-2822
bspears@winstead.com

Via Federal Express
and E-mail

The Honorable John Cornyn
United States Senate
517 Hart Senate Office Bldg.
Washington, DC 20510

Re: Bankruptcy Venue Reform

Dear Senator Cornyn:

I write in support of reform of the Bankruptcy Code's current venue provisions.

I am a twenty-three year bankruptcy practitioner and head of the bankruptcy practice for our law firm. I additionally serve as Vice President (Business Bankruptcy) of the Bankruptcy Section of the State Bar of Texas and am national co-chair of the Unsecured Trade Creditors' Committee of the American Bankruptcy Institute. My practice, while focused in Texas, brings me before courts throughout the country – particularly those in Delaware and New York.

Practicing in Texas, I have personal experience with the unfortunate practice of companies and their counsel shopping for forums. Whether to escape the watchful eye of employees, creditors or the press, numerous companies from around the country have filed bankruptcy cases in the District of Delaware or the Southern District of New York to obtain what they believed would be either favorable treatment or a venue for their bankruptcy cases which would in large measure frustrate the rights and interests of their creditors and employees. It is for these reasons, among others, that I strongly support a modification of the Bankruptcy Venue Statute and urge prompt action.

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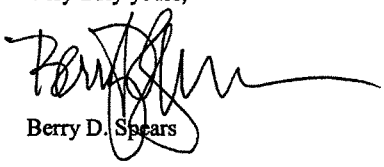
The Honorable John Cornyn
February 4, 2005
Page 2

If I can be of any assistance to you, please do not hesitate to call upon me.

Best regards.

Very truly yours,



Berry D. Spears

BDS/lh

cc: Mr. Pete Olson
Chief of Staff
Office of U. S. Senator John Cornyn

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Prepared Statement of Philip L. Strauss, Principal Attorney, Retired
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San Francisco, California 94105
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Relating to Testimony Before
United States Senate
Committee on the Judiciary
February 10, 2005

I welcome the opportunity to discuss the effect the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" will have on the collection of child support and alimony when a support debtor has filed a petition for relief under the Bankruptcy Code. For the past 31 years I was employed as an attorney by the City and County of San Francisco, the last 28 of which was spent establishing and enforcing support obligations in the Family Support Bureau of the Office of the District Attorney. At the end of 2000 the Bureau became the Department of Child Support Services, an independent county agency operated in compliance with the federal child support program under Title IV-D of the Social Security Act. For the last 16 years I specialized in the collection of support during bankruptcy and have taught this subject to attorneys both in California and nationally. I have litigated bankruptcy support cases before the numerous bankruptcy courts, the district court for the Northern District of California, the Ninth Circuit Bankruptcy Appellate Panel, and the Ninth Circuit Court of Appeals. I retired from the service in San Francisco in 2004.

Seven years ago I proposed amendments to the Bankruptcy Code which were incorporated in bankruptcy reform legislation of the 105th, 106th, 107th and 108th Congresses. The original language of those amendments was subsequently refined in a collaborative effort between myself and other child support attorneys in coordination with the National Association of Attorneys General. These amendments were adopted pretty must verbatim in the bankruptcy reform conference

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00199 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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reports of the 105th through the 108th Congresses and now appear in the current bill, S 256. It is my opinion, and the opinion of every professional support collector with whom I have discussed the issue, that the support amendments contained in Sections 211 through 219 of S 256 will revolutionize the enforcement of support obligations against debtors in bankruptcy. These enhancements will also result in a more efficient and economical use of attorney and court resources.

The support amendments have been endorsed by many individuals and organizations, including three national associations whose members consist of persons whose primary professional duty is the enforcement of support obligations in the federal child support enforcement program. These organizations include: the National Child Support Enforcement Association, the National Association of Attorneys General, and the National District Attorneys Association. In giving my testimony on this issue, I am authorized to speak on behalf of the National Child Support Enforcement Association. The membership of these organizations carries out the federal child support enforcement program in the states.

During the past 17 years in which I have taught the subject of support enforcement during bankruptcy, I have appeared continuously in bankruptcy court, written a manual for support attorneys to use when dealing with bankruptcy cases filed by support debtors, counseled support attorneys in handling bankruptcy cases , and have reviewed virtually every court opinion written on this subject since the enactment of the Bankruptcy code in 1978. Based on this experience, I developed, in association with my colleagues, what essentially became a "wish list" of amendments to the Bankruptcy Code aimed at facilitating support collection from bankruptcy debtors. This wish list is reflected in sections 211 - 214 and 216 - 217 of S 256. In this statement I will discuss not only how these amendment affect support debtors during bankruptcy, but what they mean in the larger

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00200 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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context of support enforcement generally.

Before discussing specific sections, I would like to comment on the overall effect of these amendments. I believe they achieve the following: (1) a reduction in the need to appear in bankruptcy court and the consequential reduction in the cost and uncertainty of litigation; (2) a reduction in the current conflicts in law and policy between the Bankruptcy Code and the federal child support enforcement program [Social Security Act, Title IV-D]; (3) reasonable insurance that significant support enforcement mechanisms will not be frustrated by the bankruptcy process; and (4) a clear recognition of the policy that all generally recognized support debts are entitled to a preferential treatment in bankruptcy.

The most important amendment is found in section 214 which removes several significant collection remedies from the effect of the automatic stay. Of these, the most valuable by far, is a provision allowing the continued operation of an earnings withholding order for support as defined in the Social Security Act. [42 U.S.C. 666(b)]. Since state courts or administrative agencies have already determined the appropriate level of support and arrearage payment, the removal of withholding orders from the reach of the stay will require a support debtor to design his or her bankruptcy plan to accommodate support debts--the most serious and primary of all financial obligations. Under current bankruptcy law the reverse is true. The support creditor is often forced to take a back seat to ordinary commercial creditors when a support arrearage payment is sought in a bankruptcy case.

The importance of this amendment cannot be underestimated. Federal law requires all support to be paid by employees through wage withholding orders. Such orders account for the

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00201 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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lion's share of support collection receipts.[1] Under current bankruptcy law, when a debtor files for protection under Chapters 12 or 13, the collection of even ongoing support is stayed. The economic detriment to a debtor's family, which is not receiving public assistance, can be devastating. Surely sound public policy must recognize that there are some obligations which must be met, even when a debtor should be relieved from obligations to ordinary debtors. Of these, none can be greater than the payment of support needed for the health and welfare of the debtor's family.

All too often a domestic court may reduce the current support order to accommodate the payment of arrears. In such cases the total amount of payment through the assignment order may not only be helpful, but crucial, in providing for the daily needs of the debtor's spouse, former spouse, and children.

This amendment, therefore, not only insures that the payment of support by wage earners will not be interrupted by bankruptcy, it will also avoid the need to entangle the debtor's family in the bankruptcy process. Under current bankruptcy law the support creditors would have to seek relief from the automatic stay in bankruptcy court in order to re-institute the earnings withholding order ***and*** file a claim to collect arrearage debt from the bankruptcy trustee. And even if these procedures were performed by an attorney provided by federal the child support program, delays in support enforcement would be inevitable and the outcome unsure. For support creditors who cannot afford an attorney, receipt of support may simply cease.

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[1] According to the Committee on Ways and Means, U.S. House of Representatives, 1998 Green Book, p. 572, 56% of support collected in (1996) was collected through the wage withholding process.

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In addition to the removal of the earnings withholding process from the automatic stay, other federally mandated collection processes would be exempt under section 214 of the bill. These include the interception of the debtor's income tax refunds to pay support arrears; the license revocation procedures for those debtors who are not paying support; the continued enforcement of medical support obligations; and the continued reporting of support delinquencies to credit reporting agencies.[2]

Perhaps the second most important and useful amendment to the Code is found in section 213 of the bill which prevents a debtor from obtaining confirmation of a bankruptcy plan and a subsequent discharge if that debtor has not made full payment of all support first becoming due after the petition date. This section is significant for two reasons. First it will prevent a support debtor from paying other debts at the expense of familial obligations. And second, this provision is self-executing. Neither the support creditor, an attorney for the creditor, nor a public attorney will have to seek enforcement of this provision in bankruptcy court.

In addition this section allows a support creditor to seek dismissal of an ongoing plan at any time the debtor fails to pay the on-going support payment. These provisions working together, provide crucial check points at three stages in the bankruptcy process. At the earlier confirmation stage, the support debtor will be reminded that payment of all important current support obligation is a critical step in getting approval of a bankruptcy plan as well as the lesson that payment of this

[2] In addition to the exclusion of enforcement remedies from the reach of the automatic, other family law issues are excluded from the stay, specifically (1) litigation of child custody and visitation issues, and (2) issues relating to domestic violence.

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obligation is essential to financial rehabilitation. It will set an example for the debtor early in the bankruptcy process. Further, since the goal of the debtor is to obtain a discharge of debt, this debtor will, at the outset of his case, understand that the failure to meet continuing support obligations will also doom the prospects of discharge at the end of the bankruptcy process. Finally, the creditor will have the option to seek a dismissal of the case during the bankruptcy process if the support debtor ceases to honor payment of on-going support obligations.

Section 211 of S 256 provides a definition of support obligations. This definition is then incorporated in other areas of the Code. The purpose of this definitional addition is to streamline the provisions of the Code dealing with support debts and to give all debts generally recognized as deriving from support obligations similar treatment in the Code. This provision will not necessarily change current law, but it will resolve many conflicting bankruptcy decisions which turn upon very technical interpretations of what a support debt is and what it might not be. Most significantly, highly arcane decisions concerning the dischargeability of such debts will be made moot and litigation over these issues minimized. Finally, support debts of all kinds will be subject to the same dischargeability, lien avoidance, and preference recovery rules.

Under current law only a lien securing unassigned support is exempted from statutory lien avoidance procedures. With the new definition of support in section 211, all support obligations will be excepted from lien avoidance procedures. Not only will this change protect the tax payer when the debt is assigned to the government, it may also benefit the support creditor/parent who assigned the debt if the debt becomes unassigned under the assignment rules established in the 1996 welfare reform legislation (the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 or PRWORA). For example, under current bankruptcy law if a support debtor files a Chapter 7

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00204 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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case when the support obligation has been assigned to the government under the Social Security Act, the bankruptcy court may rule that a lien securing this debt impairs the debtor's homestead exemption and then void it. The debtor would then be free to sell or encumber the property. If this property were the only known asset of the debtor, the debt would become uncollectible. If the support creditor then ceased receiving public assistance, that debt, now *unassigned* would likewise be uncollectible. However, under section 216 of S 256, the lien would not be removed and the support debt would remain secured and thus collectible.

Under current bankruptcy law if the debtor pays support during the 90 day period prior to filing a bankruptcy petition, the bankruptcy trustee cannot recover this payment for the benefit of the bankruptcy estate unless the debt is assigned. Under section 217 of S 256 the trustee would not be able to recover any support paid by the support debtor during the preference period. This rule significantly benefits the debtor because this debt is not dischargeable and would otherwise remain owing if the support debt were recovered for the estate as a preference.

No more significant statement of public policy has been made concerning the primacy of the payment of support debts than that found in section 212 of S 256. Here the Code provides child support with the first priority for payment of unsecured claims. This section is divided into two sub-priorities so that distribution within the child support priority will go first to the family of the debtor, then to the government after the family has been paid, if the support has been assigned.

When these proposed amendments are reviewed, it is not difficult to see why support enforcement professionals so strongly endorse them. Many of these amendments literally remove bankruptcy as an obstacle to support enforcement, and they do so in a self-executing manner. Consequently, no claims or stay litigation is required to continue the collection of a support debt

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when an earnings withholding order is feasible; no confirmation litigation is be needed when the debtor is not paying a postpetition preconfirmation support order; and no dismissal or stay relief litigation would be required to insure postpetition support is paid before a discharge may be granted.

Avoiding the necessity of litigation in bankruptcy court is important to support creditors and their attorneys. Even when a support creditor is financially able to hire a bankruptcy attorney, litigation of support issues in bankruptcy is likely to eat up large chunks of recoverable support. Most support creditors would be totally lost if required to navigate through the complex set of rules and procedures to seek relief in bankruptcy court without counsel. And government support attorneys are generally ill equipped to litigate bankruptcy issues and do not have the luxury of referring the case to bankruptcy specialists. After all, it should be remembered that the law of bankruptcy is a speciality with its own bar, judges, code, rules, procedures and, indeed, its own language.

Some criticism has been raised that bankruptcy reform would be detrimental to women and children because it would pit them against banks, credit card companies, or other financial institutions for collection of nondischarged credit card debt. Although this argument has some surface logic, no support collection professional that I know believes this concern to be serious. Of course, if support and credit card creditors were playing on a level field, banks with superior resources might have an advantage. However, nonbankruptcy law has so tilted the field in favor of support creditors that competition with financial institutions for the collection of post-discharge debts presents no problems for support collectors.

In the first place the ubiquitous earnings withholding process for support collection absolutely trumps any financial institution's attempt to collect this debt from the debtor's wages or

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salary since withholding orders have priority, ***no matter when issued or served***. In most cases, if the support collection was 25% or more of the debtor's wages, the Consumer Credit Protection Act would lock out the financial institution from collection of its debt from the debtor's wages. Thus, with respect to creditors of wage earners, there is no conceivable way that the existence of postpetition credit card debt, dischargeable under current law, would adversely affect the collection of support.

Even when the debtor is not a wage earner, support creditors have numerous and highly significant advantages over other creditors. While this list is certainly not exhaustive, support creditors have the following remedies not possessed by other creditors, and certainly not credit card or other financial creditors: (a) support debts are already reduced to judgments and have the advantages of court process to collect judgments; (b) **tax intercept** collection; (c) interception of **unemployment benefits**/worker compensation benefits; (d) **free** or low cost **collection services** by the government; (e) **license revocation** for nonpayment of support; (f) free or low cost **interstate collection**, including interstate wage withholding and interstate real property liens; (g) **criminal prosecution** or **contempt actions**; (h) **no avoidance of judicial liens** securing the support debt; (i) **federal collection** and **prosecution** for support debts; (j) **denial of passports**; (k) collection from otherwise protected sources: ERISA plans, trusts, and federal remuneration.

To say that these advantageous remedies will necessarily result in the collection of support is not possible. Many support debtors are actually quite skillful evaders of support obligations. These same people will probably be just as adept at avoiding collectors from financial institutions. The point to be made, however, is not that support debts will necessarily be collected after bankruptcy, but that the collection of support debt is in no way hampered simply because credit

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card debt has survived bankruptcy and financial institutions are going to attempt to collect it.

Some have argued that after bankruptcy a support debtor will be inclined to pay credit card debt to retain a credit card and not pay support. Of course, this argument assumes that after bankruptcy the debtor will find an institution willing to extend credit. Even if one did, it seems unlikely that retention of a credit card would be more important than retention of a driver's license, staying out of jail, or keeping a passport.

The bottom line as I see it in analyzing S 256 with respect to its effect on the collection of support is to note that the advantages explicit in the bill far outweigh any speculative concerns that some debtors might not pay support if they are left with credit card debt after bankruptcy. What concerns support collection professionals the most in carrying out their duties is not competition with financial institutions ***outside*** bankruptcy, but competition with other general creditors, including financial institutions, ***during*** bankruptcy. S 256 readjusts the relative strength of support creditors during the bankruptcy process, giving them meaningful, even crucial, assistance. The support provisions of this bill certainly justify the approval given them by virtually all of the national public child support collection organizations in this country.

In addition to these remarks I am also including my legislative analysis of the bill in order to address more detailed questions regarding the effect and legal underpinnings of S 256.

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LEGISLATIVE ANALYSIS OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005
Subtitle B -- Priority Child Support

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I. HISTORICAL TREATMENT OF SUPPORT DEBTS IN BANKRUPTCY

Bankruptcy law has long recognized the legal and moral importance of the payment of obligations incurred by a debtor for the support of his or her spouse and children. As such, it has striven to avoid having bankruptcy become a haven for those who would avoid such obligations or an inadvertent impediment for those who wish to comply with those obligations. However, the treatment of domestic support in bankruptcy had developed somewhat haphazardly over time as new issues and concerns have been raised and addressed piecemeal. Moreover, the Code had lagged behind in dealing with the changing legal status of payments made to governmental entities for such obligations, specifically whether such payments were to be paid directly to support the child or family of the debtor, or were to be retained by the government because the parent or child was receiving public assistance.

Under current nonbankruptcy law the status of a support obligation may change rapidly as the recipient moves on or off government assistance even though the underlying responsibility to support the child or family is unaltered. Thus, there is little reason for payments of domestic support obligations to governmental entities not to be treated equally with payments of such obligations directly to a parent or child, or for a debtor to have a lesser duty to satisfy those debts.

Prior to the Bankruptcy Reform Act the principle of favored treatment for all domestic support obligations had only been partially recognized in the Code, and there were a number of areas in which bankruptcy filings impacted domestic matters which were not dealt with at all. Accordingly, the Reform Act has undertaken a comprehensive review of all aspects of the treatment of domestic support obligations under the Code to create a coherent and consistent structure to deal with such obligations in bankruptcy.

The following basic principles were employed in drafting the support amendments contained in the Reform Act:

1. Bankruptcy should interfere as little as possible with the establishment and collection of on-going obligations for support, as allowed in State family law courts.

2. The Bankruptcy Code should provide a broad and comprehensive definition of support, which should then receive favored treatment in the bankruptcy process.

42675.163

3. The bankruptcy process should insure the continued payment of on-going support and any support arrearage with minimal need for participation in the process by support creditors.

4. The bankruptcy process should be structured to allow a debtor to liquidate nondischargeable debt to the greatest extent possible within the context of a bankruptcy case and emerge from the process with the freshest start feasible.

There were a number of areas under former law where these goals were not met. Support and debts in the nature of support were not treated uniformly in the Bankruptcy Code or by bankruptcy courts. Conspicuously, debts owed to the government and based upon the payment of government funds for the maintenance and support of the children or family of the debtor were not given the advantages which the Code affords to debts payable directly to the family of the debtor. Specifically, support debts assigned or owed to the government on the petition date have not been entitled to any priority under §507(a), have not been protected from loss of their secured status under §522(f)(1)(A), and have been recoverable by the trustee as a preference under §547(c)(7)(A). Conversely, support debts which were not assigned on the petition date were entitled to superior treatment as provided in sections 507(a)(7), 522(f)(1)(A), and 547(c)(7)(A).

Because support debts which are assigned to a governmental entity when a petition is filed may become unassigned during the course of a Chapter 12 or 13 bankruptcy plan, and vice-versa,[1] the disparate treatment of these debts in the Bankruptcy Code makes little sense. A family which is in need of support after assistance terminates certainly should not lose the advantages the Code gives unassigned support simply because the support was assigned on the petition date. The contrary was also true. Governmental entities under former law received the advantages given to the creditor of unassigned support when the support became assigned during bankruptcy. An overriding purpose of Subtitle B is to eliminate substantially such distinctions in the treatment of support obligations.

[1] The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (frequently referred to as "Welfare Reform") provides that a support arrearage which is assigned when the applicant is granted public assistance may become unassigned when assistance terminated. 42 U.S.C. §657. Since recipients of assistance lose their benefits after 60 months, it is increasingly likely that their status will change during the term of a 3 - 5 year Chapter 12 or 13 bankruptcy plan. See 42 U.S.C. §608(a)(7). Moreover, many recipients of public assistance, encouraged to leave welfare through work incentive programs far earlier than the 60 month limit, may be in the greatest need for repayment of accrued support arrears.

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In addition to the disparate treatment of support debts found in the Code, the courts also drew distinctions with respect to the dischargeability of support debts owed to the government and support debts owed to the parent or child of the debtor. These distinctions were often arcane and technical. To illustrate, if the debts were owed to the government and based upon the payment of public assistance, the dischargeability of such debts turned on the irrelevant circumstance of when the aid was paid. As a result, judgment debts for support based upon the payment of public assistance prior to the date a petition for on-going support was entered could be discharged while an arrearage accrued under an on-going order could not, even when the support debts were based on identical criteria.[2] And contributing to a lack of uniformity, the decisional law was not consistent.[3] Moreover, many debts which were incurred by a debtor based upon the responsibility of a governmental entity to provide for the support and maintenance of a child, but which debts were never owed to the child or family of the debtor directly, could be discharged. In particular the following were found to be dischargeable: debts incurred for the costs of maintenance of a child in a juvenile detention facility;[4] debts incurred to support a child who was made a ward of the state;[5] debts for support which had not been reduced to a judgment at the time the bankruptcy petition was filed;[6] and debts for child support and maintenance resulting from the placement of the debtor's children in shelter care facilities.[7] In all of these situations debtors have the same legal, equitable, and moral obligations to provide for the support of their children, but under the peculiarities of former law they could transfer that burden to the taxpayers. This Bankruptcy Reform Act is designed to insure compliance with those obligations, during and after bankruptcy.

II. SUPPORT DEBTS ARE BROADLY DEFINED

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[2] See, e.g., *In re Platter*, 140 F.3d 676 (7th Cir. 1998); *County of Contra Costa* v. *Visness*, 57 F.3d 775 (9th Cir. 1995), *cert. denied* __U.S.__, 116 S.Ct. 828, 133 L.Ed.2d 770 (1996); *County of Santa Clara* v. *Ramirez*, 795 F.2d 1494 (9th Cir. 1986), *cert. denied*, 481 U.S. 1003, 107 S.Ct. 1624, 95 L.Ed.2d 198 (1987).

[3] *In re Stovall*, 721 F.2d 1133 (7th Cir. 1983); *In re Carlson*, 176 B.R. 890 (Bkrtcy.D.Minn. 1995); *In re Jones*, 94 B.R. 99 (Bkrtcy.N.D.Ohio 1988); *In re Walden*, 60 B.R. 641 (Bkrtcy.M.D.Fla. 1986); *In re McLean*, 59 B.R. 675 (Bkrtcy.E.D.Va. 1986); *State of Oregon* v. *Richards*, 45 B.R. 811 (D.Ore. 1984); *In re Mojica*, 30 B.R. 925 (Bkrtcy.E.D.N.Y. 1983); *In re Leach*, 15 B.R. 1005 (Bkrtcy.D.Conn. 1981).

[4] *In re Crouch*, 199 B.R. 690 (9th Cir.BAP 1996).

[5] *In re Saafir*, 192 B.R. 964 (Bkrtcy.D.Neb. 1996); *In re Erfourth*, 126 B.R. 736 (Bkrtcy.W.D.Mich. 1991).

[6] *In re Furlong*, 155 B.R. 517 (Bkrtcy.W.D.Mo. 1993).

[7] *In re Spinks*, 233 B.R. 820 (Bkrtcy.S.D.Ill. 1999).

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Sec. 211: New Term Defined: Domestic Support Obligation. Intended to Include all Support and Support Related Debts

To ensure that *all* debts relating to the support of a debtor's spouse, former spouse, family or child are given a similar treatment in bankruptcy, section 211 of the Reform Act provides a sweeping definition for the concept of a "domestic support obligation." This definition is intended to clarify the following:

1. The domestic support obligation includes interest on that obligation as provided under applicable nonbankruptcy law. Thus, if a State provides for prejudgment or postjudgment interest on support, such interest is included in the definition of a domestic support obligation.

2. To be nondischargeable support, the obligation must be *owed to* or *recoverable by* a "spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative[8]" or the debt must be owed to a governmental unit. As distinguished from former law as interpreted by the courts, the debt no longer need be owed to the person or entity filing the claim. It need only be recoverable by such entity. This definition is meant to preserve present statutory or decisional law affecting the dischargeability of debts in the nature of support owed to attorneys or other persons or entities providing assistance to the creditor spouse and children in a domestic proceeding.[9] Nor is there any remaining requirement that the debt be assigned to a government or recoverable under Title IV-D of the Social Security Act[10] for the debt to be excepted from discharge. The debt need only be owed to or recoverable by a governmental unit. Likewise, the debt does not become dischargeable simply because the support was ordered to be paid to the government or a nonparent. Support ordered to be paid to a legal guardian or responsible relative is also not dischargeable.

3. As under the former law, to be excepted from discharge the debt must be "in the nature of support." Unlike the former law, however, a debt based upon assistance provided by a governmental unit for the benefit of a spouse, former spouse or child of the debtor, is now specifically included as a debt in the nature of support. This classification applies whether or not the debt incurred by the debtor is specifically designated as support and whether or not the spouse, former spouse or child has a separate legal right to establish a support obligation.

4. Under former law the support debt had to made "in connection with a

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[8] This term is intended to refer to the person who is a caretaker relative responsible for a child or children and who is eligible to receive payment of support for such child or children. See 45 C.F.R. §302.38.

[9] *See, e.g., In re Chang*, 163 F.3d 1138 (9th Cir.1998); *In re Hudson*, 107 F.3d 355, 357 (5th Cir. 1997); *In re Kline*, 65 F.3d 749 (8th Cir. 1995).

[10] 42 U.S.C. §§651 *et seq.*

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00212 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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separation agreement, divorce decree, or other order of a court of record." Therefore, it was arguable that if the debt had not been reduced to an agreement, decree or order on the date a petition for relief was filed, it was not excepted from discharge. The new definition of a domestic support obligation specifies to the contrary that the debt may be established "or subject to establishment before or after an order for relief" to qualify as a nondischargeable debt.

5. Finally the definition of a domestic support obligation continues to exclude support which has been assigned to a *non*governmental entity, unless the assignment is merely made for the purpose of collecting the debt. This new definition codifies some existing case law.[11]

III. ALL SUPPORT DEBTS ARE TREATED SUBSTANTIALLY THE SAME

Having created this definition of a "domestic support obligation," the Reform Act uses it in twenty specific places. In so doing, the Act generally treats support related debts similarly, no matter how the debt arose or to whom the debt is owed.

A. Priority of Support Debts and Distribution of Support

Sec. 212: ***(1) All Domestic Support Obligations Given Priority 1***

(2) Payment of Claims for Domestic Support Obligation Debts Will Be Distributed As Required Under Nonbankruptcy Law

All domestic support obligation debts are given a first priority. Within that priority two categories of support debts are established. Support debts owed directly to support recipients, as of the date of the bankruptcy petition, are paid prior to debts owed or assigned to the government. Therefore all claims filed as priority 1 (A) would be paid by the trustee prior to claims filed as priority 1 (B).

When, however, such claims are filed by a governmental unit and that unit receives payments on the claim, the subsequent application and distribution of moneys are governed not by the claim as it existed on the petition date, but by nonbankruptcy law applicable to such governmental units. Thus, receipt of money claimed as a priority 1 (A) debt may be distributed by the government to reimburse itself for the payment of public assistance if the creditor assigns that debt to the government postpetition. Likewise, debts which are assigned to the government prepetition and claimed as priority 1 (B) debts will be distributed directly to the support obligee if the debt is no longer assigned as of the date the government received the funds.

Other changes in distribution may also occur. If the trustee pays a governmental entity on a claim in one month, and the debtor owes but has not paid a support order accruing in that

[11] *In re Beverly*, 196 B.R. 128, 132-133; *In re Smith*, 180 B.R. 648 (D.Utah, 1995); *In re Reichurdt*, 27 B.R. 751, 753 (Bkrtcy.W.D.Wash. 1983); *Matter of Begin*, 19 B.R. 759, 761.

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month, the governmental unit may credit the payment to the current month's obligation, not to the claim. The governmental unit may also credit any payment received on the claim against newly accrued postpetition judgment interest, rather than against the principal portion of the claim. The purpose of these rules relating to governmental support claims is to allow the distribution of money received as support in the same manner it would be distributed if the debtor had not filed a bankruptcy petition.

B. Dischargeability of Domestic Debts

Sec. 215: All "Domestic Support Obligations" Nondischargeable

This Act now makes all domestic support obligations nondischargeable. The most significant effect of this change is that all debts owed to a governmental entity which are derived from payments by the government to meet needs of the debtor's family for support and maintenance are excepted from discharge. This change will nullify the holdings cited in footnotes 2, 4, 5, 6, and 7. By repealing §523(a)(18) and amending §523(a)(5), all "domestic support obligations" as broadly defined in new section 101(14A) of the Bankruptcy Code are excepted from discharge.

Section 215 also makes nondischargeable all non-support debts incurred in connection with a divorce or separation. Previously such debts may have been determined to be nondischargeable only if the support creditor brought a timely proceeding to determine the dischargeability of the debt and proved not only that the debtor had the ability to pay the debt but that discharging the debt would result in a benefit to the creditor which outweighed the detriment to the debtor. This provision gives debts resulting from the division of property the same protection from discharge as support debts.

C. Enforcement and Protection of Domestic Support Obligations

Sec. 216: (1) Exempt Assets Are Not Protected From Domestic Support Creditors

(2) Application of Exempt Assets to Support Debts is a Matter of Federal Law

(3) No Judicial Liens Securing Payment of Any Domestic Support Obligation May be Avoided

Section 522(c)(1) of the Code, as amended by Section 216 of the Bankruptcy Reform Act, incorporates the new definition of a domestic support obligation into the existing provision which subjects otherwise exempt assets to debts for nondischargeable taxes and support obligations. This principle is expanded under the Bankruptcy Reform Act to preempt state law and specifically provide that under federal law such exempt property must be made available to satisfy a domestic support obligation, notwithstanding state law to the contrary. The purpose of this provision is to nullify the Fifth Circuit *en banc* holding in *Matter of Davis*, 170 F.3d 475 (5th Cir. 1999), and to

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00214 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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reinstate the holding of the original Fifth Circuit panel.[12]

Section 522(f)(1) allows a debtor to avoid judicial liens on exempt property, but contains an exception for liens which secured unassigned child support. The Bankruptcy Reform Act extends this exception to domestic support obligations. Therefore, any judicial lien placed on the debtor's property which secures a support related obligation, whether assigned or not, may not be avoided even though the lien impairs the exemption to which the debtor would otherwise have been entitled.

Sec. 217: ***No Payment of Any Domestic Support Obligation May be Recovered as a Preferential Transfer***

Section 547(c)(7) previously barred the trustee for recovering, as a preferential transfer, *bona fide* payments of an *unassigned* support obligations. The Bankruptcy Reform Act extends this exception to all domestic support obligations, including those assigned to the government.

IV. THE AUTOMATIC STAY

Sec. 214: ***New Support Related Exceptions to the Automatic Stay***

a. Exceptions to Collect Support Include All Domestic Support Obligations

b. Automatic Stay Inapplicable to Collection of Current Support and any Support Arrearage from Non-estate and Estate Property

c. Automatic Stay Inapplicable to License Revocation

c. Automatic Stay Inapplicable to Credit Reporting

d. Automatic Stay Inapplicable to the Tax Refund Intercept Program

e. Automatic Stay Inapplicable to Enforcement of Medical Support Obligations

[12] *Matter of Davis*, 105 F.3d 1017 (5th Cir. 1999).

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The Bankruptcy Reform Act also adds additional exceptions to the automatic stay. Under §362(a) various activities of creditors are stayed once a bankruptcy petition has been filed. Under former law there were exceptions to the automatic stay which permitted the establishment of paternity, and the establishment or modification of a support order but they did not deal with a number of other domestic issues.[13] In addition, under former law the automatic stay did not apply to the collection of support so long as it was collected from property which was not property of the bankruptcy estate.[14] Since property of the estate included debtor's income in Chapter 12 and 13 cases,[15] at least until confirmation of the plan,[16] a support creditor had no way of enforcing payment of either on-going support or a prepetition support arrearage unless the obligor/debtor paid these debts voluntarily or the creditor obtained relief from the stay. These amendments deal with both issues. They include the following:

1. The existing exceptions are amended to refer to the new definition of a domestic support obligation. Additional language is added to clarify that certain other family-related matters such as custody, divorce, and domestic violence proceedings may continue to be pursued without obtaining relief from the automatic stay except to the extent a divorce proceeding seeks to deal with the division of estate property. Property division issues in a divorce are not intended to impinge on the exclusive jurisdiction of the bankruptcy court over estate assets.

2. Section 362(b)(2)(C) is added to provide for the withholding of income from property of the debtor or from *property of the estate* for the payment of a domestic support obligation. In this provision Congress has divested the bankruptcy court of exclusive jurisdiction over the bankruptcy estate to the extent a debtor's wages are estate property. Under prior law such withholding would have been allowed only if it were determined that the debtor's income was no longer property of the estate. This section specifically allows the use of estate property to pay support through the wage withholding process without any bankruptcy imposed limitation.[17] The purpose of this provision is to allow income withholding to be implemented or to continue after a Chapter 11, 12 or 13 petition is filed, just as it would if a Chapter 7 petition were filed.[18] The income withholding provisions were

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[13] 11 U.S.C. §362(b)(2)(A).

[14] 11 U.S.C. §362(b)(2)(B).

[15] 11 U.S.C. §§1207, 1306.

[16] 11 U.S.C. §§1227(b), 1327(b).

[17] Of course other laws may limit such collection such as state exemption laws and the Consumer Credit Protection Act, 15 U.S.C. §1673.

[18] Under current law in Chapter 7 and 11 cases, earnings and §541 property acquired postpetition are not property of the estate and may be seized to satisfy support arrears without violating the automatic stay, *In the Matter of Daugherty*, 117 B.R. 515, 517-518 (Bkrtcy.D.Neb. 1990). *See also*, *Matter of Hellums*, 772 F.2d 379 (7th Cir. 1985). While the Bankruptcy Reform Act now makes the postpetition individual earnings of Chapter 11 debtors property of the estate, this amendment will insure that they remain liable for enforcement of a domestic support obligation.

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enacted to allow compliance with procedures mandated in the Child Support Enforcement Program, Social Security Act, Title IV-D.[19] Income withholding applies to the collection of on-going support and any support arrearage. It may be implemented by court order or through an administrative process.

[19] See 42 U.S.C. §§666(a)(1), 666(a)(8), and 666(b).

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00217 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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3. Use of other support enforcement techniques are also excepted from the reach of the automatic stay. Under §362(b)(2)(D) the withholding, suspension, or restriction of drivers' licenses, professional and occupational licenses, and recreational licenses under state law as provided in the Social Security Act[20] is not stayed. Nor under §362(b)(2)(E) is the reporting of overdue support to a consumer reporting agency as required by the Social Security Act.[21] Also excepted from the automatic stay under §362(b)(2)(F) is the interception of tax refunds as required by the Social Security Act.[22] Thus, refunds which are payable to the debtor by the State taxing authorities or the IRS, and even refunds which the debtor intends to include or includes in his or her bankruptcy estate, may be seized to satisfy support obligations as required or allowed under State and federal law without requiring relief from the automatic stay. Finally, under §362(b)(2)(G) the enforcement of medical support obligations as mandated by the Social Security Act[23] is not stayed.

V. CHECK POINTS TO ENSURE COMPLIANCE WITH SUPPORT ORDERS

Sec. 213: ***(1) Provides for the Conversion or Dismissal of the Petition of a Debtor Who Does Not Remain Current in the Payment of a Domestic Support Obligation***

(2) Automatic Denial of Confirmation of Plan of Debtor Who Does Not Remain Current in the Payment of Postpetition Support

(3) Automatic Denial of Discharge of Debtor Who Has Not Paid All Support Required to Be Paid During Bankruptcy

(4) Allows (But Does Not Require) Debtor to Include Payment of Postpetition Interest In Plan

Section 213 sets up four check points to ensure that debtors are complying with their domestic support obligations when they have filed a bankruptcy case under Chapters 11, 12, and 13.

1. A case can be converted or dismissed at any time if the debtor does not remain current in the payment of an on-going support obligation. Under former law the Code did not explicitly require such payments or mandate an early termination of a plan when a debtor was not in compliance with an on-going support order, although some courts used their discretion to dismiss such cases for "cause." The Act allows the court to convert or dismiss a Chapter 12 or 13 plan for

[20] 42 U.S.C. §666(a)(16).

[21] 42 U.S.C. §666(a)(7).

[22] 42 U.S.C. §§664, 666(a)(3).

[23] See 42 U.S.C. §§666(a)(19).

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failure of the debtor to pay postpetition on-going support.[24]

[24] 11 U.S.C. §1208(c)(10) added by Sec. 213 (2)(C) of the Act; 11 U.S.C. §1307(c)(11) added by Sec. 213(7)(C) of the Act.

VerDate 0ct 09 2002 12:32 Jun 12, 2008 Jkt 042675 PO 00000 Frm 00219 Fmt 6633 Sfmt 6633 S:\GPO\HEARINGS\42675.TXT SJUD1 PsN: CMORC

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2. To be confirmed a plan must provide for payment of all past due priority claims for domestic support obligations.[25] The Code does, however, provide two exceptions. It allows a creditor the option of accepting less than full payment under the plan.[26] It also allows a debtor to "cram down" a less than full payment plan for priority support debts which are assigned to a governmental entity, so long as the plan provides for payment of all disposable income of the debtor for the maximum five year period allowed for a plan in Chapters 12 and 13.[27] However, since these debts will not be discharged in any event, the debtor will be given a substantial incentive to propose and complete such a plan.

3. A plan under Chapters 11, 12, and 13 may not be confirmed unless the debtor has remained current in the payment of all support first becoming due postpetition.[28] Nor can a debtor in a Chapter 12 or 13 case obtain a discharge unless all support becoming due postpetition has been paid.[29] These provisions are designed to be self-executing, at least to the extent they do not require affirmative action on the part of a support creditor to implement them. Payment of domestic support obligation arrears, in order to receive a discharge, is required only to the extent "provided for by the plan." Thus, agreements made at the time of confirmation to accept less than full payment or the use of "cram down" rights possessed by the debtor may allow the debtor to receive a discharge without full payment of all prepetition domestic support obligations. Of course, completion of such

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[25] Full payment of priority claims as a condition of confirmation of Chapter 12 or 13 plans existed under former law. See 11 U.S.C. §§1222(a)(2), 1322(a)(2).

[26] 11 U.S.C. §§1222(a)(2), 1322(a)(2).

[27] 11 U.S.C. §1222(a)(4) added by Sec. 213(3)C) of the Act; 11 U.S.C. §1322(a)(4) added by Sec. 213(8)(C) of the Act.

[28] 11 U.S.C. §1129(a)(4) added by Sec. 213(1) of the Act; 11 U.S.C. §1225(a)(7) added by Sec. 213(5)(C) of the Act; 11 U.S.C. §1325(a)(7) added by Sec. 213(10)(C) of the Act.

[29] 11 U.S.C. §1228(a) amended by Sec. 213(6) of the Act; 11 U.S.C. §1328(a) amended by Sec. 213(11) of the Act.

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a plan would not discharge any remaining domestic support obligations, but would allow the debtor to be relieved from other debts covered by the general discharge under the relevant chapter.

4. The Act allows, but does not require, the debtor to include in a plan the payment of postpetition interest on a nondischargeable debt if the debtor is able to do so after paying other debts. This provision is a departure from former law which did not allow a claim for interest, unless the claim was secured, even though interest continued to accrue on nondischargeable debts.[30] As a result, even if the debtor provided for full payment of the prepetition support debt, this debtor would be left at the end of the plan with a remaining debt for interest. Accordingly, while a debtor will often not have sufficient income to make postpetition interest payments, the debtor may wish, if feasible, to make such payments in order to obtain a fresh start at the completion of the plan.

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[30] 11 U.S.C. §502(b)(5).

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WINSTEAD

direct dial: 214/745-5324
mtucker@winstead.com

February 9, 2005

Honorable John Cornyn
United States Senate
Washington, D.C. 20510

Re: Senate Bill S.314 (Fairness in Bankruptcy Litigation Act of 2005)

Dear Senator Cornyn:

I have reviewed the text of the above referenced Bill which I understand you have sponsored. As an active bankruptcy practitioner over the last 25 years, I whole-heartedly support this effort to provide much needed protection for consumers, creditors, workers and others by reforming the rules governing venue in bankruptcy cases to combat forum shopping.

You may or may not recall that last year on June 10, 2004, I wrote you a letter concerning another "bankruptcy fairness" concern, namely the development by our federal courts of appeals of an "equitable mootness" rule which allows appeals courts to dodge review of bankruptcy appeals. A copy of my letter of June 10, 2004 as well as its enclosed memo on the topic of "equitable mootness" is enclosed for your review. Last year I had suggested that this be presented as an amendment to the Federal Courts Improvement Act of 2004, however, I understand that the Senate took no action on that proposed Act in the prior session.

It also occurs to me that my suggested reform to the bankruptcy appeal statute might also be considered to be a friendly amendment to a recent Bill sponsored by Senator Grassley, namely S.256 (Bankruptcy Abuse Prevention and Consumer Protection Act of 2005). In section 1233 of S.256, Senator Grassley has sponsored amendments to section 158 of title 28, which would permit direct appeals of bankruptcy matters to courts of appeals. My proposed amendment would also amend section 158 of title 28.

In sum, I would urge that you consider the merits of proposing an amendment along the lines of the following in either S.314 or S.256:

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Senator John Cornyn
February 9, 2005
Page 2

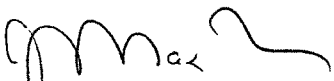
"BANKRUPTCY APPEALS.

Section 158 of title 28, United States Code, is amended by inserting as a new subsection (e):

Except as provided in section 363(m) and section 364(e) of title 11, United States Code, the inability of a party to obtain a stay pending appeal of a judgment, order or decree of a bankruptcy judge shall not limit the jurisdiction of the district court, bankruptcy appellate panel, or court of appeals to reach the merits of an appeal and to reverse the judgment, order and decree. Upon reversal of an order of confirmation that was not stayed pending appeal, the bankruptcy judge to whom the matter is remanded may take into account any good faith reliance by parties to a confirmation order in fashioning the form and amount of restitution to be awarded the party or parties that prevailed on appeal."

In conclusion, Senator Cornyn, we are requesting your thoughtful consideration of this proposed amendment. Let me know how I can help in your efforts on S.314.

Very truly yours,



J. Maxwell Tucker

JMT/kh
Enclosures

STATEMENT OF MARIA T. VULLO

I appear today to urge this Committee to amend the U.S. Bankruptcy Code to prevent extremists from abusing the bankruptcy process to avoid paying judgments obtained under the Freedom of Access to Clinic Entrances Act (FACE). I am lead counsel for the plaintiffs in *Planned Parenthood of the Columbia/Willamette, Inc., et al.* v. *American Coalition of Life Activists, et al.*, No. 95-1671-JO (D. Or.), a case in which a Portland, Oregon jury, on February 2, 1999, awarded $109 million under FACE against the defendants for their illegal threats against the plaintiffs' lives. The *en banc* Ninth Circuit affirmed the judgment, and the U.S. Supreme Court denied defendants' petition for a writ of certiorari, on remand the district court reaffirmed the punitive damages award.

Despite extensive litigation and our court victories, the defendants have resisted every lawful attempt at judgment collection and have misused the Bankruptcy Code well beyond Congressional intent. An amendment is necessary to prevent further abuse of our court system.

By way of background, at a one-month trial, the jury and the judge found that three separate items constituted illegal threats under the FACE statute. Defendants' threats consisted of "wanted" style posters that followed a pattern of similar posters targeting three physicians -- Drs. David Gunn, George Patterson and John Bayard Britton -- who were murdered following the distribution of the "wanted" posters naming them. These "wanted" poster threats are specifically addressed in the legislative history of the FACE statute.

The organization through which the defendants issued their illegal threats, was called the American Coalition of Life Activists (ACLA), an organization that

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required its leaders to be "judgment proof." Following the 1994 enactment of FACE, in January 1995, ACLA released the first threat involved in the Oregon case, which was called the "Deadly Dozen List." The Deadly Dozen List issued by ACLA contained the names and home addresses of thirteen physicians from around the nation -- three of whom were plaintiffs in the Oregon suit. Immediately after the issuance of this threat, the FBI and the United States Marshal's Service contacted the physicians on the List, informing them that they should consider this a serious threat to their lives, advising them to take security measures, and offering them 24-hour federal marshal protection.

At an event later that year in August 1995 held in St. Louis, Missouri, the defendants issued their second direct threat, again under the ACLA name. This "wanted" style poster targeted another of our physician clients and included his photograph and other personal identifying information. Again, the doctor named on this "wanted" poster was contacted by law enforcement and undertook significant precautions to ensure his and his family's personal safety.

The third threat involved in the Oregon case was called the "Nuremberg Files." Amidst images of dripping blood, the "Nuremberg Files" website contained the names and addresses of doctors and other health care workers around the country who provide reproductive health services, some including their children's names. Doctors who are still working appeared in plain text; those who have been wounded were "greyed out"; and those who have been murdered -- including Barnett Slepian who was murdered in front of his family in October 1998 -- had a line crossing out their names. After learning of this website, the FBI again contacted the named physicians and advised them accordingly.

After the verdict, the federal district judge, the Hon. Robert E. Jones, issued an injunction to prevent further threats against the plaintiffs and the judge included findings of fact to support that injunction. Among other findings, the trial judge found as follows:

> I conclude from my independent review of the evidence produced at trial that plaintiffs have proven by clear and convincing evidence that each defendant, acting independently and as a co-conspirator, prepared, published and disseminated the "Deadly Dozen" Poster, the Poster of Dr. Robert Crist and the "Nuremberg Files" with specific intent and malice in a blatant and illegal communication of true threats to kill, assault or do bodily harm to each of the plaintiffs with the specific intent to interfere with or intimidate the plaintiffs from engaging in legal medical practices and procedures.

41 F. Supp. 2d at 1154.

As the jury and judge learned during the course of the trial, my clients no longer enjoy the basic freedoms that most of us take for granted. Although they are medical professionals who live and work in relatively safe communities around the country, they have been forced to live as if under constant threat of imminent attack: they have purchased and regularly wear bullet-proof vests; they have installed extensive security systems including bullet-proof glass and reinforced steel in their homes and offices; they have warned their children's teachers of the threats by defendants; they have developed emergency plans should they come under attack, including instructing a young child to hide in the bathtub should he hear gunshots; they vary their routes to and from work to protect themselves from assailants; they have installed window coverings to thwart snipers; they have purchased and wear disguises to avoid being recognized; and they are ever-vigilant in public. They are not secure in their homes or in their offices. They do not sit by windows in restaurants. And they even refrain from hugging their children in front of open windows.

The passage of FACE has had a significant positive impact on the lives and safety of reproductive health care workers. We need this statute – and its continued enforcement – to save lives. But the statute cannot be fully enforceable if those who are found liable for violating the law are able to evade their obligations simply by filing for bankruptcy and avoiding the consequences of their illegal actions. After years of litigation – including up to the Supreme Court – defendants in the Nuremberg Files case have tried to nullify years of court proceedings by the mere filing of a Chapter 7 bankruptcy petition. This is an abuse of process.

I have been extensively involved in litigating the very issue before this Committee in six different bankruptcy courts across the country. Following the jury's verdict in February 1999, my firm proceeded to enforce the judgment that our clients had obtained after years of litigation and a month-long trial. Following the jury's verdict, the defendants announced that they did not intend to pay any of the amount awarded by the jury. Their statements were consistent with defendants' own so-called Constitution, which specifically required the organization's leaders to be judgment proof. At page 4 of the document, under the heading "Doctrine and Character," the ACLA Constitution states that members of the organization "must . . . have their assets protected form [sic] possible civil lawsuits (judgment-proof)." The defendants intentionally sought to make themselves judgment proof precisely to avoid having to pay any part of the judgment that my clients obtained. When we found assets, they used the court system to seek to avoid their legal obligations. These are not honest debtors who find themselves in dire financial straits through acts beyond their control, and who seek to work out their debts owed to creditors. They are <u>not</u> the individuals that the Bankruptcy Code was enacted to protect.

For example, defendant Michael Bray -- who served years in federal prison for multiple clinic arson attacks -- was one of the six defendants to seek bankruptcy protection following the jury's verdict in the Oregon case. Bray responded to the Judge's injunction by saying, "I have no plans to submit to those kinds of unconstitutional edicts." Bray also stated that "there's no money to be had" and that he has no intention of changing his behavior although, he said, "I may have to get creative about it, though." In a newsletter written by Bray after he filed for bankruptcy, Bray also discussed the deposition for which he never appeared and noted with respect to the Court's discovery orders requiring the production of documents, "I am good with matches." On the day of his ordered deposition, Bray filed for bankruptcy -- and he abused the Bankruptcy Code by doing so. Now, after years of litigation, he is out of bankruptcy but we recently had to seek relief for his violations of court orders respecting his assets.

Despite the jury's verdict, and the District Court's explicit findings of specific intent and malice, the defendants expected to obtain a "discharge" in bankruptcy -- and thus not pay a single cent to the plaintiffs in satisfaction of the judgment. After months of trying to obtain discovery of their assets, six defendants filed for chapter 7 bankruptcy in six different bankruptcy courts.

In the now five years since the jury's verdict, my firm has committed enormous resources to enforcing the judgment, including by representing the plaintiffs in six different bankruptcy courts. In connection with these bankruptcy proceedings, the defendants took the position that the jury's verdict is fully dischargeable in bankruptcy, despite the "willful and malicious injury" exception to discharge that currently exists in

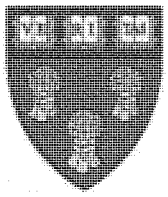
the Bankruptcy Code. These filings, and the relitigation that has followed, demonstrate the utmost importance of an amendment to the U.S. Bankruptcy Code.

Because an amendment that I would urge be proposed does not currently exist, the defendants were able to invoke the protection of the automatic stay of the Bankruptcy Code, and force relitigation of the "willful and malicious injury" issue in the various bankruptcy courts across the country. This has been a lengthy and expensive process, involving a separate trustee and a separate judge in each case -- each of whom has had to familiarize himself or herself with the case. Because these defendants live in different parts of the country, my law firm had to proceed against them in six different bankruptcy courts. In each case, we had to commence an adversary proceeding in bankruptcy, file motions for summary judgment setting forth the prior proceedings and legal principles, and appear in those courts for multiple hearings. My firm expended over 3,500 attorney hours in litigating these bankruptcy proceedings, in addition to the time spent by local counsel in each jurisdiction and the substantial expense of filing fees, service fees, and travel around the country.

After extensive litigation and considerable expense over a period of four plus years, we won the "willful and malicious injury" issue in the bankruptcy courts. Enactment of an amendment to the Bankruptcy Code is necessary because defendants should not have been given the opportunity to litigate the issue of their discharge in bankruptcy. There is no doubt that these defendants did not seek relief from the bankruptcy courts as part of a good faith effort to work with plaintiffs on a payment plan. Rather, after years of litigation, defendants made it clear that they intended to seek a full "discharge" in bankruptcy and thus not pay one cent to their creditors. Without an amendment, this type of abuse will continue.

Thus, it is my considered position, based upon my personal experience litigating the current law of "willful and malicious injury," that in order to preserve law and order, the Bankruptcy Code must be amended so that the bankruptcy process is not abused any further. Whatever one's position on abortion, we all can agree that criminals should not get away with acts of violence and threats of violence. The evidence at trial was undisputed that, upon the release of defendants' threats, with the advice of law enforcement, my clients purchased bulletproof vests, installed extensive security systems at their homes and offices, and took other security precautions because of defendants' actions. The jury awarded my clients their security costs as compensatory damages, and also awarded punitive damages under FACE against each of the defendants to prevent and deter further illegal activities. Allowing these defendants to abuse the bankruptcy process to delay enforcement of this judgment totally undermines the effective enforcement of the FACE statute and the true purposes of the Bankruptcy Code. The only way to prevent this from happening again is for an amendment to the Bankruptcy Code to be enacted that unambiguously provides that FACE violations are nondischargeable in bankruptcy. Without such a clear statement, future defendants in FACE actions will continue to file for bankruptcy in order to delay any efforts to hold them responsible for their illegal actions. An amendment to the Bankruptcy Code is therefore necessary so that laws are followed and the bankruptcy process is not abused.

Thank you.



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Testimony of Elizabeth Warren
February 10, 2005

My name is Elizabeth Warren. I teach bankruptcy law. As some of you know, I have followed this issue with interest for some time.

The overarching problem with this bill is that time and the American economy have passed it by. It was drafted—never mind by whom—eight years ago. Even if it had been a flawless piece of legislation then, and it surely was not, the events of the past eight years have dramatically changed the economic and social environment in which you must consider this bill.

In the eight years since this bill was introduced, new cases have burst on the scene. The names are burned in our collective memories.

- Enron
- Worldcom
- Adelphia
- United Airlines, USAirways and TWA
- LTV Steel
- K-Mart
- Polaroid
- Global Crossing

While the actual number of consumer bankruptcy cases has declined slightly in the past year, many of the largest corporate bankruptcy cases in American history have occurred since the Senate last reevaluated the bankruptcy laws, and some of those cases are already legend for the corporate scandals that accompanied them. Because it was written

eight years ago, this bill has nothing to deal with these abuses, with these dangers, with the needs that these cases have made so painfully clear.

Problems not even on the horizon when this bill was written are now front and center.

- Companies in Chapter 11 that cancel pension plans and health benefits, leaving thousands of families economically devastated
- Companies that continue to pay executives and insiders tens of millions of dollars, while they demand concessions from their creditors.
- Military families targeted for payday loans at 400% interest, insurance scams, and other forms of financial chicanery.
- Scandals have rocked the so-called non-profit credit counseling industry, exposing how tens of thousands of consumers struggling desperately to pay their bills and *not* file for bankruptcy were cheated.
- Sub-prime mortgage companies, financed by some of the best names in American banking, have unlawfully taken millions of dollars from homeowners, then fled to the bankruptcy courts to protect their insiders and bank lenders.

In the eight years since this bill was introduced, there has been a revolution in the data available to us. Unlike eight years ago, we need not have a theoretical debate about who turns to the bankruptcy system. We now know:

- One million men and women each year are turning to bankruptcy in the aftermath of a serious medical problem—and three-quarters of them have health insurance.[1]
- A family with children is nearly three times more likely to file for bankruptcy than an individual or couple with no children.[2]
- More children now live through their parents' bankruptcy than through their parents' divorce.[3]

Unlike eight years ago, we need not have a theoretical debate about the homestead exemption because we have had example after example of abuse tied directly to the failure of American companies. Millions of jobs have been lost but not the Florida and Texas fortunes of their corporate executives. Others are welcome to use the unlimited homestead exemption as well.[4]

- After he lost a $33 million dollar lawsuit in California, O.J. Simpson moved to Florida, explaining to a reporter that the unlimited exemption would permit him to protect a multimillion-dollar house.

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[1] Himmelstein, et al, *Illness and Injury as Contributors to Bankruptcy*, Health Affairs Online Exclusive (February 2, 2005).
[2] Warren and Tyagi, *The Two-Income Trap: Why Middle Class Mothers and Fathers Are Going Broke* at 6 (2003).
[3] *The Two-Income Trap*, at 176-77.
[4] Richard Westlund, *Loophole: Why Big Debtors Love Florida Real Estate*, Florida Horizons, at 39-40 (2003).

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- Abe Grossman ran up $233 million in debts in Massachusetts and Rhode Island, then fled to Florida to purchase a 64,000 square foot home valued at $55 million.
- Some physicians are reportedly dropping their malpractice insurance and putting all their assets in their homes—where they can't be touched by bankruptcy.

Under S. 256, they would still be welcome to file for bankruptcy and to keep their fortunes and properties intact while leaving their creditors with nothing.

Unlike eight years ago, we need not have a theoretical debate about the effects of the proposed legislation on small business.

- It takes time to negotiate a reorganization, even for a small company. The timelines in S. 256 would have denied reorganization to more than a third of the small businesses that eventually saved themselves—destroying value for the companies, their creditors, their employees and their communities.[5]
- This bill would be the first in American history to discriminate affirmatively against small businesses. For the first time ever, Congress would pass a law that says companies like Enron and Worldcom don't have to file extra forms, Enron and Worldcom don't have to schedule meetings with the Office of the United States Trustee, and Enron and Worldcom don't have to meet fixed deadlines that a judge cannot waive for any reason—but every troubled small business in the Chapter 11 system would have to file those papers, undergo that supervision and meet those deadlines or be liquidated. No exceptions allowed—for small companies.

Unlike eight years ago, we need not have a theoretical debate about the economic impact of bankruptcies on credit card company profits.

- In the eight years since this bill was introduced, credit has not been curtailed. Minors—under 18 years of age—with no incomes and no credit history are now described as an "emerging market" for the credit industry.[6] Credit card solicitations have doubled to 5 billion a year. Bankruptcy filings have increased 17%, while credit card profits have increased 163%, from $11.5 billion to $30.2 billion.[7]
- Some courts have demanded that credit card companies disclose how much of their claims are the amounts actually borrowed and how much are fees, penalties

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[5] Edward R. Morrison, "Bankruptcy Decisionmaking: An Empirical Study of Shutdown Decisions in Small Business Bankruptcies" (Columbia Law School, February 2005) (estimates based on cases filed in the Northern District of Illinois).

[6] *Credit Report Questions Answered by Experian*, Chapter 13 Trustee Newsletter (January 2001) (Q: Can credit card offers be made of minors? A: Yes. While a seemingly greater credit risk, young adults (under 18 years of age) are emerging credit customers, particularly those about to graduate from high school and enter the college ranks.)

[7] CardWeb.com, Inc./RAM Research Group Frederick, Maryland (http//www.cardweb.com) (1997 Annualized Credit Card Profits: $11.5 billion; 2004 Annualized Credit Card Profits: $30.2 billion).

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and interest. Companies have admitted that for every dollar they claim the customer borrowed, they are demanding two more dollars in fees and interest.[8]

- With increased fees and universal default clauses that drive up interest rates even for customers paying on time, a growing number of people have no option but to declare bankruptcy. Cases continue to surface like *In re McCarthy*,[9] in which a woman borrowed $2200, paid back $2010 in the two years before bankruptcy, and was told by her credit card company that she *still* owed $2600 more. Ms. McCarthy had two choices: She could either declare bankruptcy or she could pay $2000 every year for life—and die owing as much as she owes today.

The means test in this bill, Section 102, has been one of its most controversial provisions. Proponents like to say that the means test will put pressure *only* on the families that can afford to repay. And yet, the bill has 217 sections that run for 239 pages. The means test aside, virtually every consumer provision aims in the same direction. The bill increases the cost of bankruptcy protection for *every* family, regardless of income or the cause of financial crisis, and it decreases the protection of bankruptcy for *every* family, regardless of income or the cause of the financial crisis.

There are provisions that will make Chapter 13 impossible for many of the debtors who would file today, provisions that make it easier than ever to abuse the unlimited homestead provisions in some states and yet at the same time hurt people with more modest homesteads in those same states. Other provisions will compromise the privacy of millions of families by putting their entire tax returns in the court files and potentially on the Internet, making them easy prey for identity thieves. Women trying to collect alimony or child support will more often be forced to compete with credit card companies that can have more of their debts declared non-dischargeable. All these provisions apply whether a person earns $20,000 a year or $200,000 a year.

But the means test as written has another, more basic problem: It treats all families alike. It assumes that everyone is in bankruptcy for the same reason—too much unnecessary spending. A family driven to bankruptcy by the increased costs of caring for an elderly parent with Alzheimer's disease is treated the same as someone who maxed out his credit cards at a casino. A person who had a heart attack is treated the same as someone who had a spending spree at the shopping mall. A mother who works two jobs and who cannot manage the prescription drugs needed for a child with diabetes is treated the same as someone who charged a bunch of credit cards with only a vague intent to repay. A person cheated by a sub-prime mortgage lender and lied to by a credit counseling agency is treated the same as a person who gamed the system in every possible way.

If Congress is determined to sort the good debtors from the bad, then it is both morally and economically imperative that they distinguish those who have worked hard and played by the rules from those who have shirked their responsibilities. If Congress is

[8] In re Blair, 02-11400, United States Bankruptcy Court for the Western District of North Carolina (February 10, 2004) (compiled from data reported in opinion).
[9] In re McCarthy, 04-10493SSM, United States Bankruptcy Court for the Eastern District of Virginia (July 14, 2004).

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determined to sort the good from the bad, then begin by sorting those who have been laid low by medical debts, those who lost their jobs, those whose breadwinners have been called to active duty and sent to Iraq, those who are caring for elderly parents and sick children from those few who overspend on frivolous purchases.

This Congress wants to set a new moral tone. Do it with the bankruptcy bill. Don't press "one-size-fits-all-and-they-are-all-bad" judgments on the very good and the very bad. Spend the time to make the hard decisions. Leave discretion with the bankruptcy judges to evaluate these families. Based on the Harvard medical study and other research, I think you will find that most debtors are filing for bankruptcy not because they had too many Rolex watches and Gameboys, but because they had no choice.

You have a choice. It's a choice that you're making for the American people. Adopt new bankruptcy legislation. Establish a means test that targets abuse. But do not enact a proposal written to address myth and mirage more than reality. Do not enact a proposal written for 1997 when the problems of the American corporate economy in 2007 deserve far more attention and the problems of the American middle class can no longer be ignored.

Overwhelmingly, American families file for bankruptcy because they have been driven there—largely by medical and economic catastrophe—not because they want to go there. Your legislation should respect that harsh reality and the families who face it.

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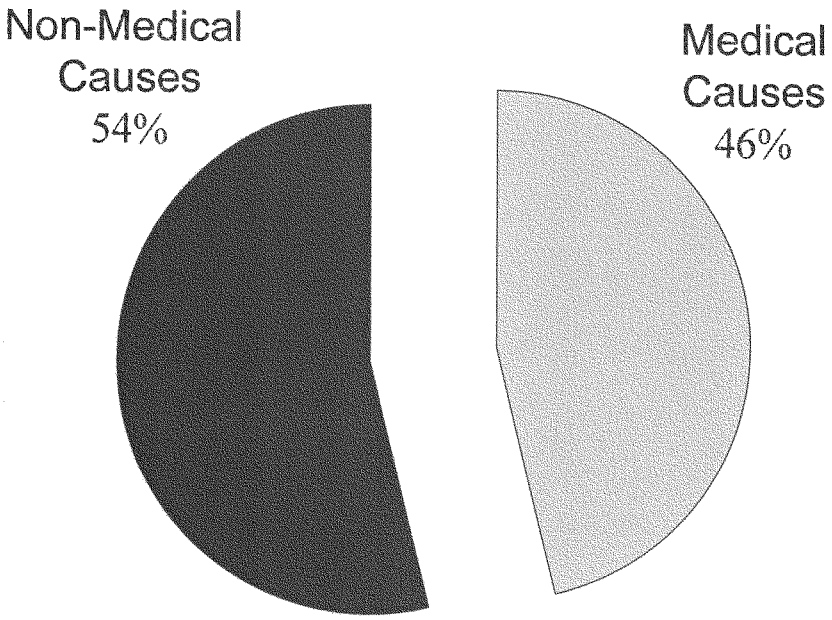
There Are 1.5 million Bankruptcies Annually: Almost Half Result from Illness



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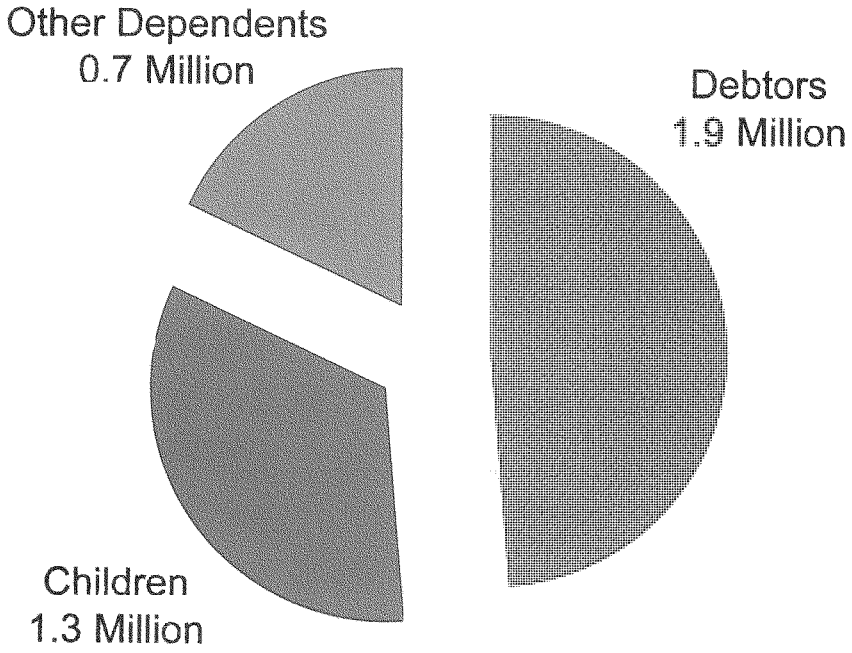
Bankruptcy is a Family Matter:
3.9 million Americans are affected



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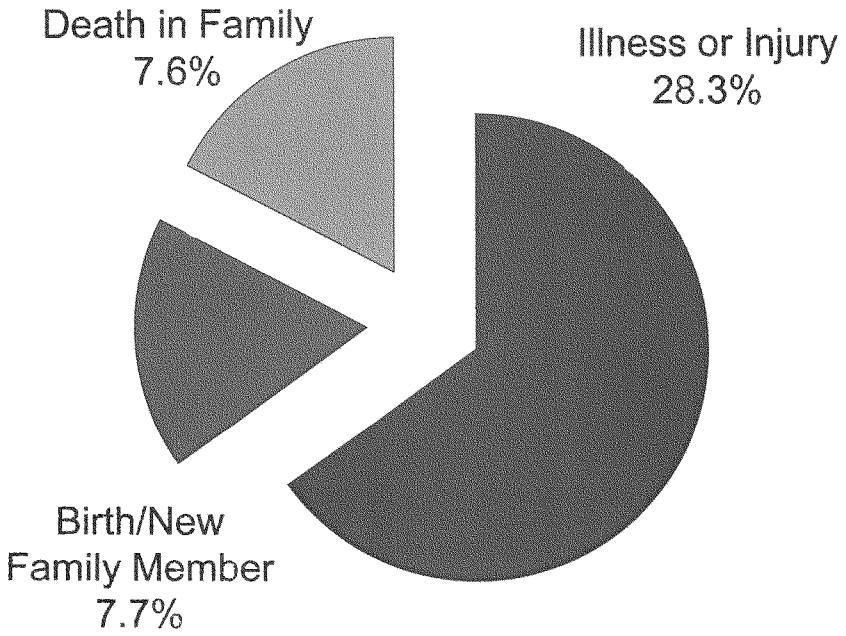
Medical Causes of Bankruptcy



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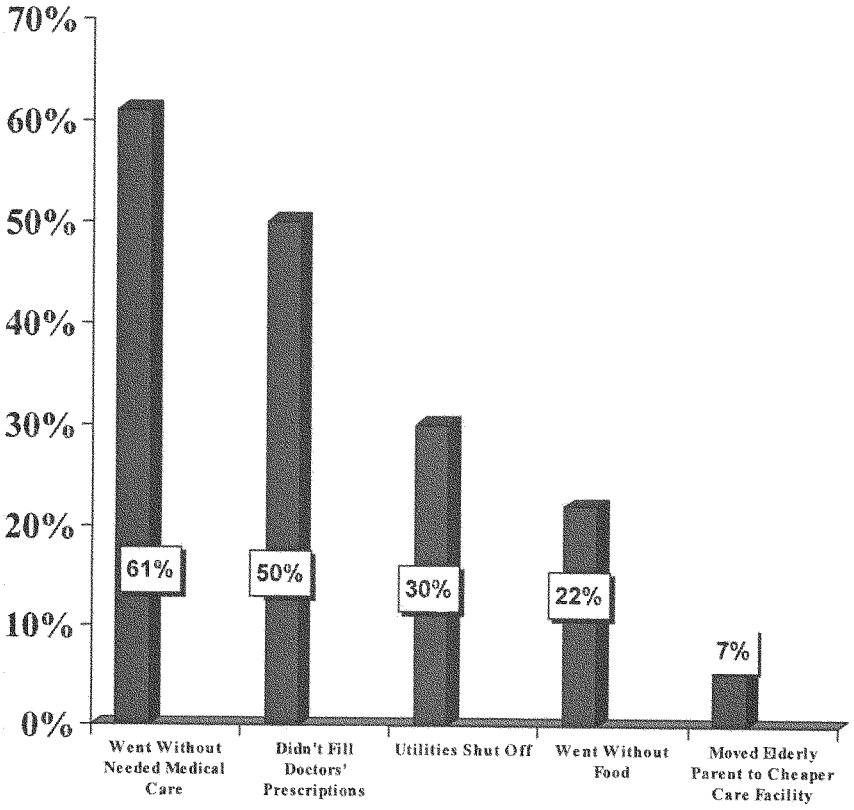
Trying to Avoid Bankruptcy



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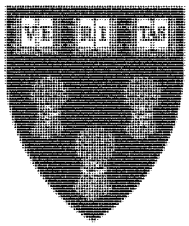

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January 31, 2005

Senator John Cornyn
617 Senate Hart Office Building
Washington, DC 20515

Dear Senator Cornyn:

Since its inception, the central promise of the federal bankruptcy system is that *all* creditors—large and small—have equal access to participate in the judicially-supervised liquidation or reorganization of the debtor. No bankruptcy will be run to benefit one group of creditors over another, or to permit the debtor to escape from close scrutiny after its financial collapse.

Unfortunately, that promise has been significantly eroded. Mega-companies and their counsel shop for courts that will render decisions that may favor the debtor, the attorneys or a small group of powerful creditors. These parties often file the bankruptcy petitions in locations far distant from most of the company's business and from most of its creditors, including its workers, retirees and local trade creditors who have made their own investments in the company.

Forum shopping creates an advantage for the insiders, while making it virtually impossible for small creditors to participate in the bankruptcy process. Employees, pensioners, trade creditors and others have claims that are important to them, but that are not large enough to justify millions of dollars in lawyers' fees or trips to distant locations. As a result, many of these smaller parties are shut out of the system. They literally cannot get to the courthouse.

Bankruptcy courts around the country are capable of handling the cases that come their way—large or small. The judges are smart and thoughtful, and the court personnel are

dedicated and hard-working. No single court in this country, regardless of its experience, should have an exclusive lock on dealing with big cases. No court has special powers or unique skills to deal with the questions of claims, property of the estate, financing, fraud, attorneys' fees and so on—issues that can arise in any case, regardless of size.

The current system of court shopping harms too many parties. Closing a loophole in the bankruptcy laws that permits this unseemly practice and forcing companies in trouble to subject themselves to the scrutiny of their local courts and local creditors is an important step toward strengthening the credibility of the bankruptcy system. The reform embodied in your proposal is real reform. If a company prospers in part because it draws on the strength of the community where it operates, that same community should be able to participate fully in its financial reorganization.

Very truly yours,

Elizabeth Warren
Leo Gottlieb Professor of Law

EW/rs

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February 6, 2005

Senator John Cornyn
617 Senate Hart Office Building
Washington, DC 20515

Dear Senator Cornyn:

There is no single reform of our Chapter 11 system that is as important as ensuring an end to the forum shopping that has so distorted that system in recent years. The present venue rules are so loosely constructed that they permit any large public company to file a Chapter 11 pretty much wherever it likes. Naturally, the management of companies in financial trouble and the professionals that advise them take advantage of those rules to choose the forum that will best serve their interests. Often that means a Chapter 11 filing in a courthouse far away from the company's home.

These rules permit the company's management to escape the close scrutiny of intensely interested local media and to avoid attendance at court hearings by employees, local suppliers, and others vitally interested in the case and knowledgeable about the company. They force smaller creditors to file claims from afar, claims that are often the subject of an arbitrary objection by the debtor that the distant creditor cannot afford to litigate. Conversely, creditors who received some payment before bankruptcy may be the subject of long-distance preference attacks that they cannot properly defend in a remote courthouse, especially if the amounts involved, although substantial, are not enough to justify the expense of a defense. Compounding the problem of expense is the creditor's lack of knowledge of lawyers in the distant forum and the risk, especially in Delaware, that in a big case most experienced local lawyers will already be committed to other clients. On top of these direct injuries to creditors, in cases where a trustee in bankruptcy is appointed, the administration of assets hundreds or thousands of miles removed from the trustee's home cannot be done efficiently and rarely can be done well.

These and other effects of forum shopping are inefficient and prejudicial. In addition, the present system imposes subtle pressures on bankruptcy judges and district judges, who cannot be unaware that their decisions as to venue will determine whether the community and the local bar will be greatly enriched by the administration of large

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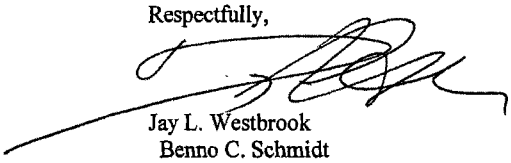
bankruptcy cases. Despite the high degree of professionalism on our federal bench, it is not reasonable to expect that these pressures will have no effect.

Although I am expressing my own opinions and not speaking for the University or the Law School, I write as someone who has practiced, studied, taught, and written about bankruptcy law for over thirty years. Please let me know if I can provide further information that would be helpful to your work.

Respectfully,



Jay L. Westbrook
Benno C. Schmidt
Chair of Business Law

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February 7, 2005

Hon. John Cornyn
Committee on the Judiciary
U.S. Senate
517 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Cornyn:

In 1996 and 1997, at the direction of the Congress, the National Bankruptcy Review Commission conducted a comprehensive assessment of the federal bankruptcy code. I was the chairperson of that nine-member, bipartisan citizen commission. Its review led to a 1500-page report and 172 recommendations for improving the country's bankruptcy law. Many of those recommendations have been incorporated in the comprehensive bankruptcy legislation that has been introduced, but never enacted, over the last eight years.

The Senate Judiciary Committee soon will take up S. 256, essentially the same bankruptcy legislation that has been before the Congress in every session since 1997. Whatever its merits, the proposal shares the same glaring defect that has characterized other bankruptcy "reform" bills. It ignores the forum shopping that has become an inefficient and prejudicial hallmark of Chapter 11's provisions for corporate reorganization.

The law today, as you well know, permits a company to choose a judicial forum in which to reorganize based on its state of incorporation or the place where an affiliated corporation has filed a Chapter 11 petition. That means that a corporation can determine its future—and the future of its employees, pensioners, suppliers, and creditors—thousands of miles from its principal place of business or the location of its principal assets. That is neither efficient nor fair.

Recognizing that, the National Bankruptcy Review Commission voted overwhelmingly (with but a single dissent) to recommend changing the bankruptcy code to limit the venue choices available to a corporate debtor. The legislation you are proposing, either as a bill or as an amendment to S. 256, would essentially codify the Commission's findings and recommendation.

As a practicing attorney in Wisconsin, I have seen major corporations in this state take their Chapter 11 proceedings to other jurisdictions. The ultimate outcome of the proceedings may or may not have been affected by the choice of venue, but it is certain that the company's employees, creditors, and suppliers in this state were deprived of a meaningful opportunity to monitor the proceedings and to participate in them effectively and efficiently.

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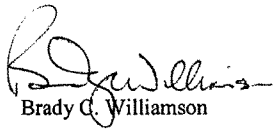
February 7, 2005
Page 2

The venue provisions of the bankruptcy code, with or without comprehensive "reform" legislation, should be changed. The empirical data support the cause of change and so do the interests of judicial economy and efficiency. The fate of major corporations, whether in Wisconsin or in Texas, should be decided by the federal courts in those states, not hundreds or thousands of miles away. I write to support your proposal. Please let me know if you have any questions about the Commission's work or its unequivocal conclusions on this important issue.



Brady C. Williamson

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February 9, 2005

U.S. Senator John Cornyn, Chairman
U.S. Senate Judiciary Subcommittee on Immigration, Border Security & Citizenship
Dirksen Senate Office Building Room 139
Washington, DC

Dear Senator Cornyn:

I strongly support legislation limiting forum shopping in bankruptcy.

Any "uniform" system administered by multiple circuits, districts, and judges will suffer from inconsistencies in rulings. The bankruptcy system, with its tremendous volume, suffers from differences in local rules, but also from case law that crystallizes into, essentially, rules (for example, how a particular judge assesses the value of a used automobile–blue book, red book, wholesale, retail, etc., etc.). Such inconsistencies are inherent in the system; the problem is that the big players have figured out how to game these inconsistencies.

If a client has enough money, its lawyers can study these inconsistencies, discover which district or judge will be the most "favorable" to one's application, and find a way to get the application before that tribunal. This process has accelerated in recent years with Delaware and New York being the venues of "choice."

This advantage is directly related to wealth and power, as such, is unavailable both to individuals and small businesses, and is unfair. What's yet worse is that courts' generosity or stinginess in attorneys fee applications may well motivate lawyers to file their clients cases in one district rather than in another. It is common knowledge in my geographic area that much of the bankruptcy business went from Philadelphia to Wilmington partly because of a contrast in the way the respective judges handled attorneys fees.

Limiting forum shopping does not eliminate this abuse but it improves the system by making it harder to abuse the system in these ways. I'm hopeful the legislation will succeed.

Sincerely,

William J. Woodward, Jr.
Professor of Law

Testimony of Professor Todd J. Zywicki

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Presented to:
The Hearing of the
Judiciary Committee of the
United States Senate
On Bankruptcy Reform

February 10, 2005

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I am pleased to testify on the subject of the Bankruptcy Reform Act. For the fourth Congress in a row, this body will be considering a bankruptcy reform bill that would bring balance and sanity to a bankruptcy system that is threatening to spiral out of control. Last year, consumer bankruptcy filings exceeded 1.6 million for the first time. Clearly the time is right to address some of the problems of fraud and abuse that is endemic in the current bankruptcy system. Recognizing this, I am pleased to see that this Committee has acted promptly to introduce a bankruptcy reform Bill and to hold hearings on the issue. I am pleased to provide my views on the matter. I am currently a Visiting Professor of Law at the Georgetown University Law Center. From 2003-04, I served an appointment as the Director of the Office of Policy Planning at the Federal Trade Commission, where I assisted in helping to shape FTC policy on matters of consumer credit, subprime lending, and related topics. I hold both a J.D. and a Master's Degree in Economics. I was also a John M. Olin Fellow in Law & Economics at the University of Virginia and am a tenured member of the faculty at George Mason University School of Law, one of the premier centers for the study of economic analysis of law. In addition to my publications in law reviews, I have also published several articles in peer-reviewed economics journals. As such, I believe that I am in a sound position to discuss both the legal and economic aspects of the current bankruptcy system as well as the probably effects of the bankruptcy reform Bill.

This Bill represents a thoughtful and well-considered effort to address many of the problems that are manifest in the bankruptcy system today. The Bill makes incremental reforms to the consumer bankruptcy system to address many of the loopholes and technicalities that opportunistic debtors have found to evade their financial and personal responsibilities. The reforms provided for by this Bill are grounded in common-sense and experience derived from the observation of the day-to-day operation of the bankruptcy system in practice.

The current system has been little-changed since its enactment in 1978. Since that time the number of personal bankruptcies is roughly five times larger than when the Code was enacted. Today, some 1.6 million Americans troop through the bankruptcy courtrooms every year. This growth in numbers has been matched by a growing sophistication among lawyers and the public about the opportunities for fraud and abuse—both legal and illegal—in the bankruptcy system. Few reasonable observers believe that even a small fraction of the fraud and abuse present in the system is caught. As a result, similarly-situated debtors and creditors throughout the country suffer from dissimilar and unpredictable treatment on the basis of accident of geography or judicial whim. By guaranteeing unequal treatment for similarly-situated individuals, the system mocks the rule of law. In turn, this undermines public confidence that the bankruptcy system is operating fairly and efficiently. Instead, it is increasingly viewed as a system prone to cynicism and manipulation, and a free-ride for debtors lacking in conscience and personal responsibility.

In a forthcoming law review article, I systematically examine the factors that have caused the rise in consumer bankruptcy filings in recent years. *See* Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, ___ NORTHWESTERN LAW REVIEW ___ (Forthcoming 2005), available at

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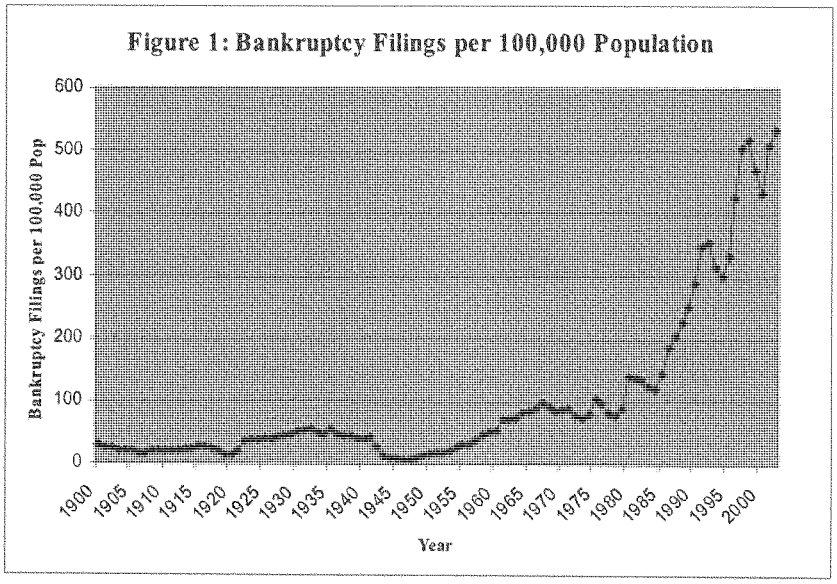
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901. The Figures presented in this Testimony are drawn from that article. In the Appendix to this Testimony I present additional discussion of the causes of the consumer bankruptcy crisis.

As Figure 1 indicates, although bankruptcy filings were low and generally cyclical for most of the Twentieth Century there has been a stunning increase in consumer bankruptcy filing rates during the past twenty-five years, which has increased at accelerating rates over the past two decades.



Source: Annual Report of the Attorney General of the United States (through 1939) and Administrative Office of the United States Courts.[1]

Astoundingly, today more bankruptcies are filed *every year* then the *entire decade of the Great Depression combined.*

In addition, since the enactment of the Bankruptcy Code in 1978, bankruptcy filings have been on an irresistible upward trend, accelerating during the 1990s:

[1] Prior to 1940, separate records were not kept for individual and business bankruptcies; nonetheless the general cyclical pattern of bankruptcy filings for the first half of the Twentieth Century is evident.

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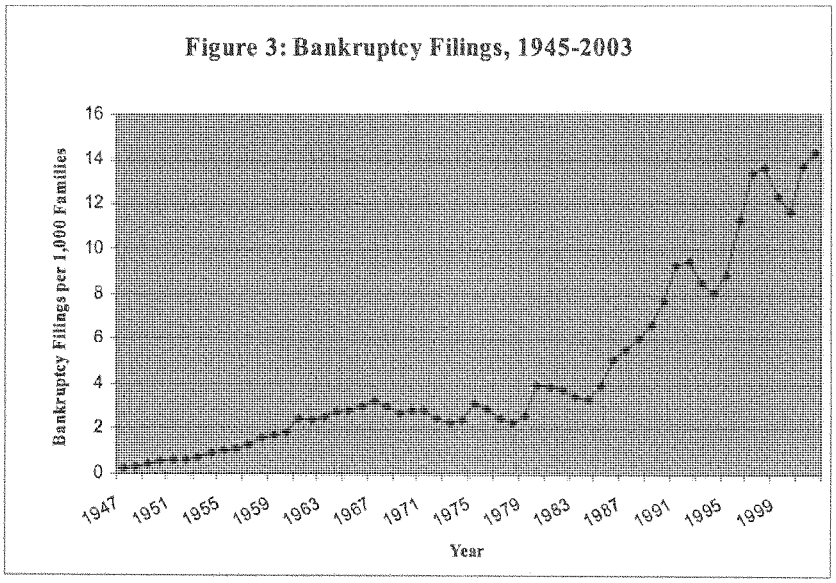

Source: Bankruptcy Filings, Admin. Office of U.S. Courts; Number Households, U.S. Census Bureau

As Figure 3 indicates, the per capita bankruptcy rate in America has dramatically risen over time, accelerating in the 1980s and 1990s. The total number of bankruptcies more than doubled during the 1980s and then doubled again from 1990 to 2003, such that by 2003 annual consumer bankruptcy filings were five times higher in 2003 than just twenty year earlier. This rapid increase in filings has been especially difficult to explain in light of the prosperous state of the American economy during most of the past two decades, and especially, the extraordinary prosperity of the late 1990s. Although the American economy set new records for economic growth, low unemployment, and low interest rates, this was matched by record-high bankruptcy filings as well.

It is thus evident from this, and the evidence presented in the Appendix to this Testimony, that today the consumer bankruptcy system today is no longer being used as a "last resort" for consumers. Instead, the anomaly of record-high bankruptcy filings after almost 20 years of uninterrupted economic prosperity indicates the need to reconsider America's consumer bankruptcy rules.

The current system suffers from a crisis of both real and perceived abuse. This Bill addresses both of these problems. This Bill rebalances the bankruptcy system, by taking sensible steps to address many of the most prominent abuses by both debtors *and* creditors that have been manifested in recent years. At the same time, it preserves the commitment to the fresh start for *all* debtors who need it. By preserving the fresh start but also addressing abusive behavior, this Bill will restore fairness and efficiency to the

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bankruptcy system and thereby restore public confidence in the system. A failure to act in a sensible and rational way today will lead to continuing abuse and continuing public frustration. Acting sensibly today will head-off more drastic and ill-considered action later.

Being pro-debtor is not the same as being pro-consumer. When some people get a free-ride in bankruptcy, the rest of us are forced to pick up the slack. The overwhelming majority of Americans pay their Bills and live up to their financial responsibilities. But it should not be forgotten that those who pay their Bills inevitably have to pay more to make up for those who do not. Bankruptcy losses are a cost of business. Like all other business expenses, when creditors are unable to collect debts because of bankruptcy, some of those losses are inevitably passed on to responsible Americans who live up to their financial obligations. Every phone bill, electric bill, mortgage, furniture purchase, medical bill, and car loan contains an implicit bankruptcy "tax" that the rest of us pay to subsidize those who do not pay their bills. Exactly how much of these bankruptcy losses is passed on from lenders to consumer borrowers is unclear, but economics tells us that at least some of it is. We all pay for bankruptcy abuse in higher down payments, higher interest rates, and higher costs for goods and services.

This bankruptcy "tax" takes many forms. It is obviously reflected in higher interest rates. But it is also reflected in higher down-payment requirements, as creditors desire greater up-front payments to reduce the risk of nonpayment. It is reflected in shorter grace periods for paying bills and higher penalty fees and late-charges for those who miss payments. Finally, it is reflected in fewer benefits to consumers, whether the co-branding benefits offered by credit cards today or such things as greater customer service or extended business hours. Retailers raise their prices or close their credit operations. Hospitals and other medical providers are forced to restrict services or increase prices still higher to compensate for unpaid medical debts. Regardless of which of these forms it takes, it is evident that the rest of us suffer when some people choose not to pay their bills.

Moreover, it is lower-income and fixed-income Americans who suffer the most, as it is they who already have the fewest credit choices and the least ability to absorb increased credit and other costs that result from avoidable bankruptcy losses. When furniture stores are forced to discontinue their credit operations because of bankruptcy losses, or when department stores are forced to raise prices to offset losses due to bankruptcy, lower-income Americans are hurt the most. When upper-income individuals file bankruptcy and walk away from debts that they could pay but choose not to, the bill gets sent to you, me, young, and low-income Americans alike. I cannot see any reason why lower-income Americans should pay a higher price for goods, services, or credit simply to preserve the privilege of upper-middle class Americans to shirk financial obligations that they can pay. Consumers as a whole, and especially low-income consumers, are not made better-off when bankruptcy losses increase prices and decrease service.

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Creditors also lose from a runaway bankruptcy system. Smaller businesses and small creditors suffer the most from a runaway bankruptcy system, as they tend to have the narrowest margins and the least ability to spread those losses among their customers. The small-town furniture store selling couches and end tables on credit suffers a lot when his customers don't pay up. As do independent car salesmen, jewelers, contractors, and other small businesses who extend credit to their customers. Thus, it is not surprising that support for bankruptcy reform comes from across the full spectrum of creditors, but small creditors, such as small retailers and credit unions, are among the strongest supporters of bankruptcy reform.

The Bill will also reinforce the lesson that bankruptcy is a moral as well as an economic decision. Filing bankruptcy reflects a decision to break a promise made to reciprocate a benefit bestowed upon you. The moral element of bankruptcy is reflected in the observation that the English word "credit" comes from the Latin word for "trust." Parents seek to teach their children values of personal and financial responsibility, and promise-keeping and reciprocity provide the foundation of a free economy and healthy civil society. Regrettably, the personal shame and social stigma that once restrained opportunistic bankruptcy filings has declined substantially in recent years. We have "defined bankruptcy deviancy downward" such that it has become a convenient financial planning tool, rather than a decision freighted with moral and social significance. Requiring those who can to repay some of their debts as a condition for bankruptcy relief sends an important signal that bankruptcy is a serious act that has moral as well as economic consequences. Moreover, reducing the number of strategic bankruptcies will reduce the bankruptcy tax paid by every American family on goods and services, giving them more money for groceries, vacations, and educational expenses.

The Bill establishes a much-needed system of means-testing to force high-income debtors who can repay a substantial portion of their debts without significant hardship to do so. Under current law, there are few checks on high-income debtors seeking to walk away from their debts and few safeguards to prevent bankruptcy fraud. Current law requires a case-by-case investigation that turns on little more than the personal predilections of the judge. The Bill narrows the judge's discretion by establishing a presumption of abuse where a high-income debtor has the ability to repay a substantial portion of his debts, as measured by an objective standard. At the same time, the judge will retain discretion to override this presumption in cases of hardship. Means-testing is not a panacea for all of the ills of the bankruptcy system. But by focusing judicial discretion on the existence of real hardship and reducing procedural hurdles to challenging abuse, the Bill's reforms will vindicate the rule of law and reduce abuse.

By targeting high-income bankrupts with substantial repayment capacity, it is estimated that means-testing will recover roughly $3 million of the $40 million discharged in bankruptcy every year. Although means-testing will affect only 7-10% of bankruptcy filers, but focusing scrutiny on those high-income debtors who can repay a substantial portion of their debts without significant hardship, the Bill makes possible the recovery of substantial losses with minimal administrative cost. Equally important, means-testing will have *no effect* on those making less than the minimum income

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threshold provided. Thus, for the 80% of filers whose income lies beneath the state median, means-testing will have no effect whatsoever.

It should also be stressed that means-testing will not prevent anyone from filing bankruptcy and receiving a bankruptcy discharge. Instead, it will simply *condition* the discharge for affected filers to pursuing a chapter 13 repayment plan rather than going into chapter 7. In fact, the means-testing rules will simply govern eligibility for chapter 7 relief; it has no impact on the confirmation of the debtor's chapter 13 plan. In approving the debtor's plan the court will still apply the budgetary processes provided for under current law without any consideration of the means-testing eligibility rules.

The means-testing provisions also provide an excellent example of the Bill's incremental and balanced approach to the problem of abuse and fraud in the system. Under current law, it is already the case that the primary factor for courts to consider in deciding whether to dismiss a debtor's case for substantial abuse under §707(b) is whether the debtor can repay a substantial portion of his debts without significant hardship. Overwhelmed by the number of cases they confront and lacking the will to enforce its provisions consistently, however, it has been observed by one scholar that many perceive §707(b) to be a "dismal failure." Jack F. Williams, *Distrust: The Rhetoric and Reality of Means-Testing*, 7 AM. BANKR. INST. L. REV. 105 (1998). The Bill simply creates a more formal and reliable mechanism for implementing the goals that bankruptcy courts are already seeking to apply, but will do so in a way that more efficient and fair than the current system. *See* Edith H. Jones and Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BRIGHAM YOUNG UNIVERSITY L. REV. 177.

In addition, the Bill strikes at the most prominent abuses concerning the unlimited homestead exemption. It prevents opportunism by debtors who move from one state to a state with an unlimited homestead exemption immediately prior to filing bankruptcy by imposing a lengthy waiting period on their ability to avail themselves of the new state's exemption. This extended waiting period thus eliminates the largest objection to the a state-based exemption regime, as empirical evidence plainly demonstrates that credit markets operate in such a manner to keep most of the cost of excessive exemptions within the state, thereby eliminating interstate spillovers. *See* Reint Gropp, John Karl Scholz, and Michelle J. White, *Personal Bankruptcy and Credit Supply and Demand*, 112 Q. J. ECON. 217 (1997). As a result, while excessive exemptions may be bad policy in that they raise the cost of credit and reduce access to credit, this tradeoff is arguably one that falls within the discretion of the various states. Second, the Bill would create a 10 year statute of limitations to attack fraudulent use of the homestead exemption. Thus, although the Bill does not contain a flat cap on the use of the homestead exemption, it does attack the two leading causes of abuse by imposing a waiting period to prevent eve of bankruptcy exemption forum shopping and providing Judges with greater powers to attack fraudulent uses of the homestead exemption.

The Bill also takes a major step to reduce other forms of fraud and abuse, including such things as the use of "fractional interests" to prevent legitimate foreclosures and abuse of the cramdown provisions of the Code by filing bankruptcy simply to strip down the value of a secured creditor's claim. It creates new protections from bankruptcy

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"mills" and ensures that bankruptcy filers undergo credit counseling to try to workout a consensual solution to their financial problems. In short, it reflects practical solutions grounded in common-sense experience regarding the problems in the bankruptcy system. Contrary to the selective outrage of its critics, however, the Bill does not limit itself to reducing abuse of the homestead exemption but takes a comprehensive approach to rooting out *all* forms of bankruptcy abuse.

In the past, it has been claimed by some that the Bill would negatively impact the ability of divorced spouses to collect spousal and child support. This claim is based on vague, speculative, and inaccurate accusations about how the nondischargeability of certain debts will impact post-petition efforts to collect these obligations. In contrast to these speculative accusations, the Bill offers concrete assistance to non-intact families in several ways. Among its numerous provisions protecting the rights of former spouses and children are the following protections: (1) Extends the scope of nondischargeability of spousal support obligations to make nondischargeable certain property settlements, (2) excepts state child support collection authorities from the reach of the automatic stay, (3) elevates the priority level of child support to first priority, (4) makes exempt property available for the enforcement of domestic and child support obligations. It is well-established that alimony and child support creditors have a substantial number of tools at their disposal that other creditors lack, such as heightened garnishment protections, government-assistance in collection, intercept power over tax refunds and government benefit payments, and many other protections.

It is thus a simple falsehood to charge that the effect of the Bill would lead to spousal support creditors having to "compete" with ordinary creditors for payment, because that is simply not the case. If this allegation is raised this time, I urge this Committee to ask *exactly* how this supposed competition takes place. The Committee will soon learn, I believe, that the allegation is unsubstantiated and amounts to little more than hand-waving. The primary problem for spousal support collection today is not a fictional competition with other creditors, but rather the obstructions and hurdles imposed by the current bankruptcy laws. The reforms in this Bill go a long way toward relieving the hurdles imposed by the bankruptcy laws that interfere with effective collection of such obligations today. This Bill *unequivocally* improves the position of divorced spouses attempting to collect alimony, child support, and property settlements. For seven years now divorced spouses and children have hoped for relief from the traps of the bankruptcy system; now is the time to give it to them.

Balanced bankruptcy reform preserves the protection of the bankruptcy system for those who need it, while limiting abuse by those who are preying on that generosity simply to evade their financial responsibilities. This Bill brings balance to a consumer bankruptcy system that has become a tool for rich and savvy debtors to evade their financial responsibilities. America has one of the most charitable and forgiving bankruptcy systems in the world and many of those who file bankruptcy truly need it as a consequence of personal trouble. But too many people today are preying on our charity and using the bankruptcy system not because they need it, but simply to evade their responsibilities or to maintain an unrealistic and extravagant lifestyle at the expense of those who live responsibly. Ignoring rampant abuse undermines public support for the

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bankruptcy system generally, which will eventually hurt those who legitimately need bankruptcy relief.

Now is the time to act to reform the bankruptcy laws. This Bill is a sensible, balanced, incremental, and well-considered attempt to deal with these problems before they become intractable. These reforms will make the bankruptcy system more fair, equitable, and efficient, not only for bankruptcy debtors and creditors, but for all Americans.

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Appendix

Understanding the Causes of the Bankruptcy Crisis and the Need for Reform

There is little evidence to support the more general proposition that the rise in consumer bankruptcy filings has been caused by an increase in household financial distress rather than other factors. This Appendix briefly reviews the evidence regarding the purported causes of the rise in consumer bankruptcy filings during the past twenty-five years. More detailed discussion can be found at Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, ___ NORTHWESTERN LAW REVIEW ___ (Forthcoming 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901.

It has been argued that the upward filing trends of the past twenty-five years has been caused by high levels of household financial distress. This argument could explain rising bankruptcies in two possible ways. First, it is argued that consumers have "too much debt," either because they have borrowed recklessly or because creditors have somehow induced them to take on excessive levels of debt, such as through overly-aggressive promotion of credit cards. This excessive debt either catapults them into bankruptcy directly by making it impossible for them to pay all their debts, or by making them more vulnerable to financial shocks. Second, it is argued that unexpected financial shocks to consumer households have become more common or more severe, thus generating more bankruptcies. Neither of these theories is borne out by the available evidence.

Bankruptcy has two well-established measures of financial distress and insolvency. The first is "equity" or liquidity insolvency, which examines the ability to generally pay one's debts as they come due. This measurement is essentially a ratio of one's current income to current expenses, including current or monthly payments on debt obligations. The second is "balance sheet" or "bankruptcy" insolvency, which finds a debtor to be insolvent if the "sum of the debtor's debts is greater than all of the debtor's assets at fair valuation." Equity insolvency is a "flow" measure of current income and expenditures; balance sheet insolvency is a "stock" measure of total assets and total debt, or household net wealth.

Equity Insolvency and Bankruptcy

The first way to measure financial condition is through equity insolvency, or the ability to pay one's debts as they come due. Since the early 1990s interest rates have fallen and loan maturities have lengthened on average. As a result, even though total household indebtedness has gradually and consistently risen during this period, the household debt service ratio has remained fairly constant. Indeed, it is likely that total indebtedness has risen *precisely* because of falling interest rates and a lengthening of loan maturities. Low interest rates enable consumers to borrow more, such as to buy a larger house, without a substantial increase in monthly payments. Figure 4 compares the Federal Reserve's measurement of the household debt service ratio with consumer bankruptcy filings:

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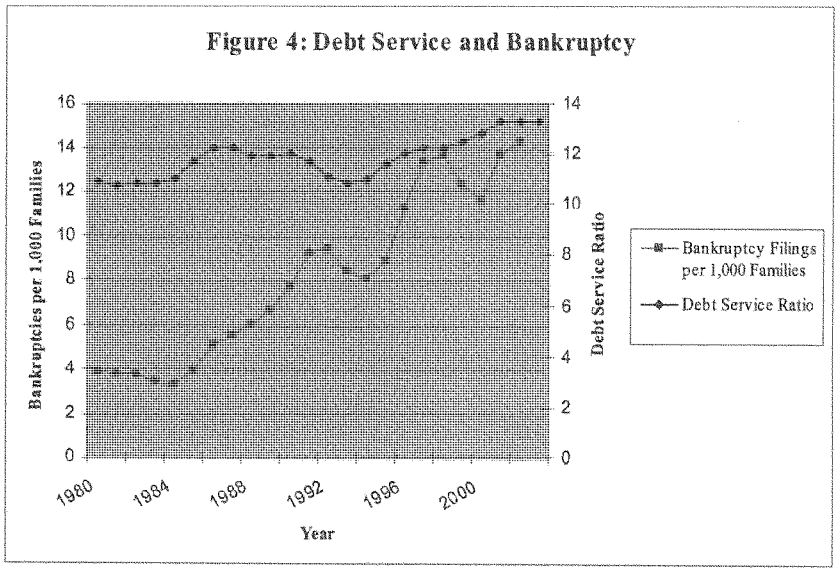

Source: Federal Reserve Board Household Debt-Service Burden and Figure 3

Moreover, the debt service ratio is relatively constant across households of varying wealth positions, in that low, medium, and high-wealth households all spend roughly the same amount of their income on current debt-service obligations, although poor and wealthy households have slightly lower debt-service burdens than middle-class households. With respect to the lowest quintile of income earners, there appears to be little relationship between changes in the debt-service burden of the lowest quintile and overall bankruptcy filing rates, as shown in Figure 5:

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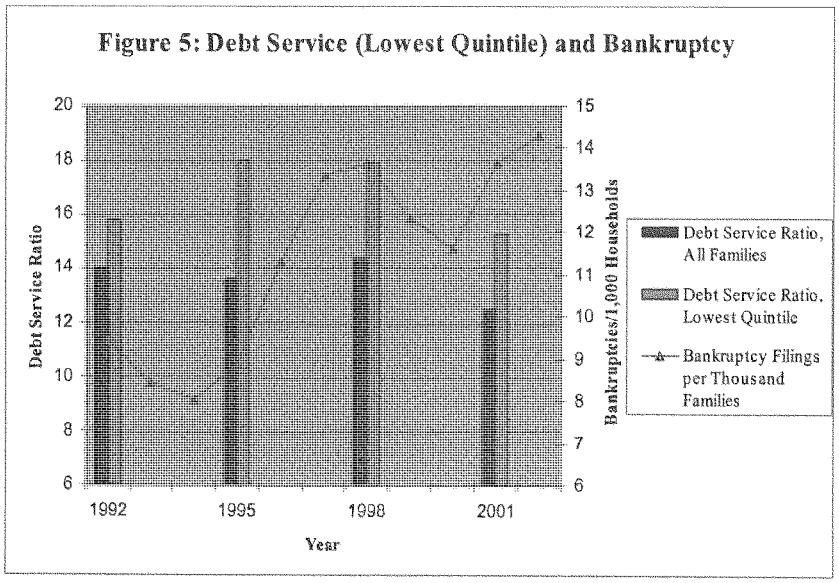

Source: Survey of Consumer Finances and Figure 3.

Whereas the debt service ratio for the lowest income quintile of the population was unchanged between 1995 and 1998, the overall bankruptcy filing rate soared. Similarly, whereas the debt service ratio fell from 1998 to 2001, bankruptcy filings were the same in 1998 and 2001. The debt service ratio of the lowest quintile was also the same in 1992 and 2001, but bankruptcies were much higher in the latter period. In short, changes in the lowest-income sector of society do not explain rising bankruptcy filing rates. Thus, the aggregate debt-service measurements are not concealing some sort of unrecognized distress among poor households.

Balance Sheet Insolvency and Bankruptcy

A second standard measure of household financial condition is the ratio of total assets to total debt, also referred to as "balance sheet" or "bankruptcy" insolvency. In the context of consumer households, balance sheet insolvency can be measured by household net wealth. Like balance sheet insolvency, household net wealth is calculated as the difference between total assets and total liabilities. As shown in Figure 6 there has been a dramatic increase in household net wealth during the era of the consumer bankruptcy crisis:

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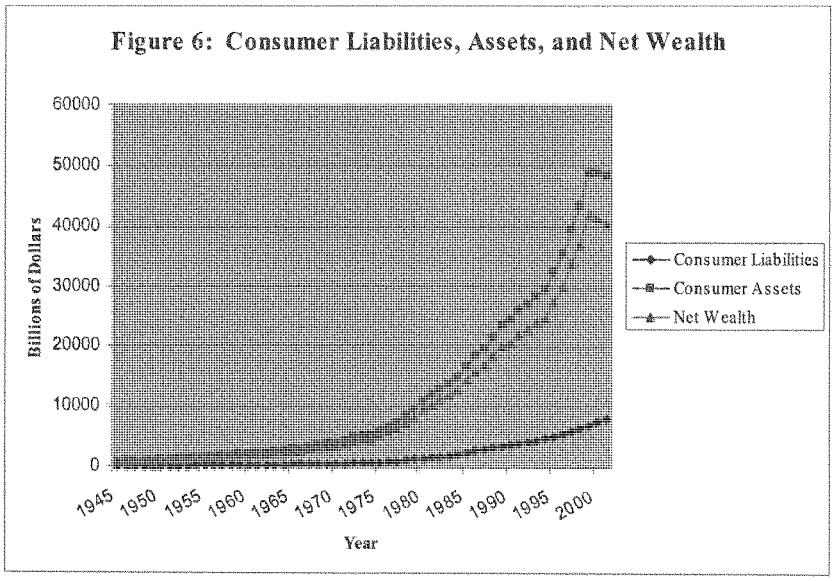

Source: Philadelphia Federal Reserve Bank[2]

Household wealth has risen steadily and dramatically over the past several decades. In fact, after a relatively stable level of net wealth for over half a century, net wealth began to rise rapidly in the 1970s, accelerating in the 1908s, and exploding in the 1990s. At the same time, bankruptcy filings have also risen steadily and dramatically. In the mid-1990s, for example, household net wealth grew by about ten percent per year, even as bankruptcies jumped as much as twenty percent per year. Moreover, the ratio of consumer credit to net worth has remained almost perfectly constant at four percent of net worth since 1956. This combination of rising bankruptcies and rising personal wealth contradicts the hypothesis that mounting bankruptcies reflects increased household financial distress.

Moreover, net wealth has risen for households of all wealth levels, including the poorest quintiles.[3] Even though the poor remain poorer than average overall, low-wealth households have benefited from the asset growth along with everyone else. As shown in Figure 7, the average net worth of the lowest quintile of households has risen slowly but steadily over the past decade:

[2] Data available at http://www.phil.frb.org/src/cf/backgrounddata5.htm

[3] *See* Arthur B. Kennickell, *A Rolling Tide: Changes in the Distribution of Wealth in the U.S., 1989-2001*, Federal Reserve Board, http://www.federalreserve.gov/pubs/oss/oss2/scfindex.html (Sept. 2003).

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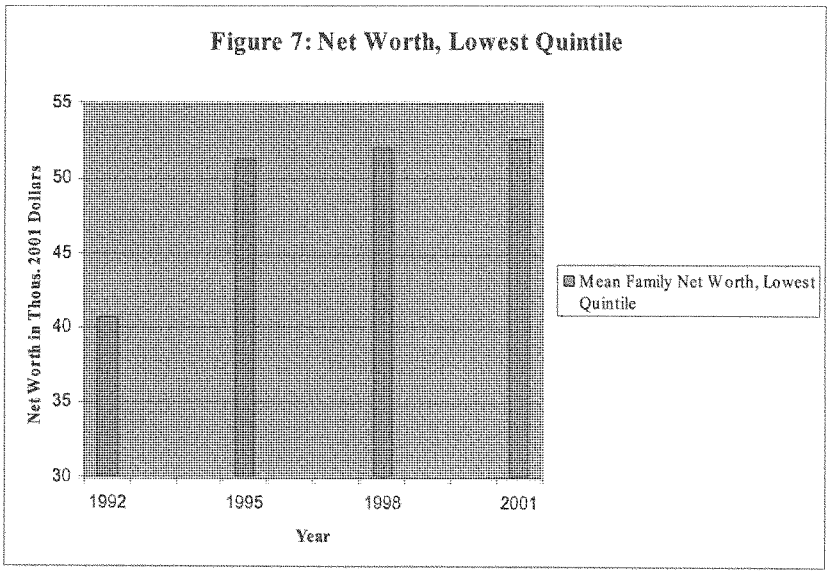

Source: Survey of Consumer Finances

Credit Cards and Bankruptcy

It has also been argued that increased use of credit cards has led to an increase in consumer indebtedness, resulting in more bankruptcies. In fact, credit cards have not worsened household financial condition, because although consumers have increased their use of credit cards as a borrowing medium, this increase represents primarily a *substitution* of credit card debt for other high-interest consumer debt. For many borrowers, credit card borrowing may be an attractive option relative to other corms of credit that are available to them, such as pawn shops, personal finance companies, retail store credit, and layaway plans, all of which are either more costly or otherwise less attractive than credit cards. The result, therefore, has not been to increase household indebtedness, but primarily to change the *composition* of debt within the household credit portfolio. This is also consistent with the finding reported above that the consumer debt-service burden has remained largely stable during this period. Figure 8 illustrates the nature of this substitution:

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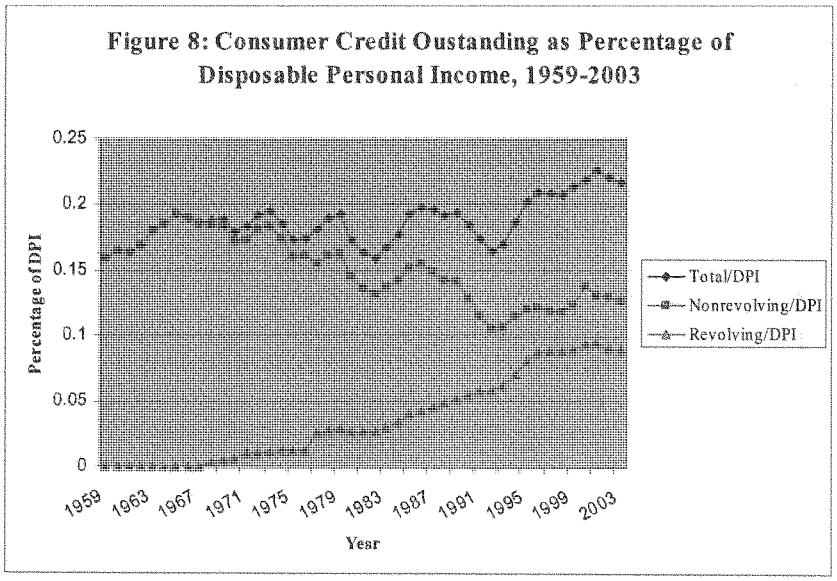

Source: Federal Reserve Board and Bureau of Economic Analysis

As Figure 8 indicates, the growth in revolving (credit card) debt has largely been a *substitution* from nonrevolving consumer debt to revolving debt, thus leaving overall consumer indebtedness (as a percentage of income) largely unaffected. Revolving debt outstanding has risen during this period from zero to roughly 9% of outstanding debt. Nonrevolving installment debt, by contrast, has fallen from its level of 19% of disposable income in the 1960s, to roughly 12% today. The increase in revolving debt has been almost exactly offset by a decrease in the installment debt burden. In fact the recent bump in total indebtedness in recent years was *not* caused by an increase in revolving debt, which has remained largely constant for several years, but by an increase in installment debt, primarily as a result of a recent increase in car loans for the purchase of new automobiles. Thus, because credit card debt has largely just substituted for other forms of consumer debt, there is little indication that increased use of credit cards has precipitated greater financial stress among American households.

It also has been argued that credit cards have contributed to increased bankruptcies through a profligate expansion of credit card credit to high-risk borrowers, especially low-income borrowers. Although often-repeated, empirical studies have failed to support this theory. First, as noted, the growth in credit card debt by low-income households primarily reflects a substitution for other types of debt, not an overall increase in indebtedness. In addition, two studies have examined the hypothesis empirically and have found little support. The first study, by economists Donald P. Morgan and Ian Toll concludes, "If lenders have become more willing to gamble on credit card loans than on

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other consumer loans credit card charge-offs should be rising at a faster rate [than non-credit card consumer loans] . . . . Contrary to the supply-side story, charge-offs on other consumer loans have risen at virtually the same rate as credit card charge-offs." Donald P. Morgan & Ian Toll, *Bad Debt Rising*, CURRENT ISSUES IN ECON AND FIN. March 1997, at 1, 4. Thus "suggest[s] that some other force [other than extension of credit cards to high-risk borrowers] is driving up bad debt." A second study, by David B. Gross and Nicholas S. Souleles, concludes that changes in the risk-composition of credit card loan portfolios "explain only a small part of the change in default rates [on credit card loans] between 1995 and 1997." David B. Gross & Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 REV. FIN. STUD. 319, 324 (2002). Moreover, if it were true that lower-income households were dramatically increasing their indebtedness through credit card increase then this should be reflected in the debt service ratio for lower-income households. As previously noted, however, this ratio has remained largely constant for lower-income households as with all others.

Housing Costs and Bankruptcy

A recent book has argued that recent decades have seen an excessive "bidding war" for housing that has led to increased financial stress. *See* ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE (2003). Most of the support for the "bidding war" hypothesis is anecdotal. The only numerical data offered to support the thesis is an example of the balance sheet of an average household in the 1970s compared to an average household in the 2000s. *Id.* at 50-51 But on closer inspection, the data that is presented does not support the "bidding war" hypothesis offered up by the authors. In the standard one-wage earner household of the 1970s, median income was $38,700. Major expenses were $1,030 a year for health insurance, $5,310 in mortgage payments, and automobile loan payments and expenses equal $5,410. The effective tax rate was 24%, equaling $9,288 from the household salary, leaving $17,834 in discretionary income. The overall family budget is described in Figure 9:

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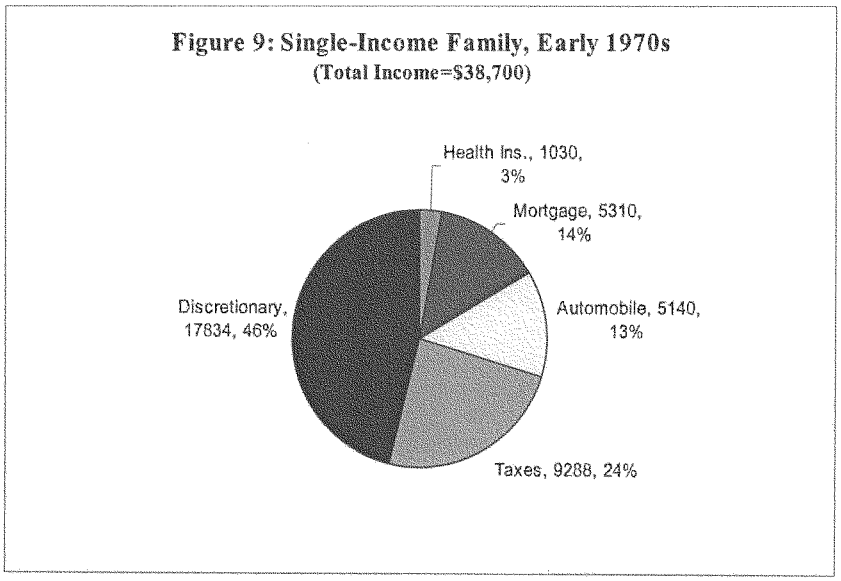

Source: Warren & Tyagi, The Two-Income Trap

In the typical 2000s family with both spouses working, total family income is $67,800. Mortgage payments are $9,000, an increase of $3,690. The expense of two cars rises to $8,000, or an increase of $2,860. Day care is now needed because both parents are working, adding a total of $9,670 for two children. Health insurance has increased to $1,650, an increase of $620. Because of progressiveness of the tax code, the higher family joint income have increased taxes to 33%, or a total of $22,374, an increase in $13,086. Discretionary income has, in fact, fallen in the second period. But this appears to be primarily the result of a much higher tax burden and additional new child care expense. As seen in Figure 10, the supposed "bidding war" for housing, by contrast, has increased the family housing expense by only $3,690:

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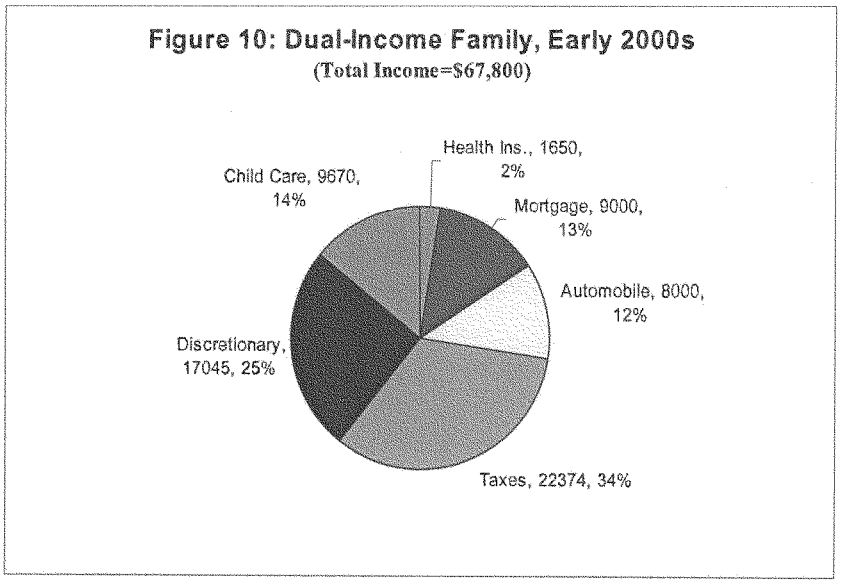

Source: Warren & Tyagi, The Two-income Trap

As Figure 10 indicates, mortgage, automobile, and health insurance expenses have all risen modestly in absolute terms from the 1970s to the early 2000s, but all have fallen as a percentage of the family budget. By contrast, taxes have increased by over $13,000, almost as much as all of the other expenses *combined*, and over three times the increase in housing expenses. Child care is a new expense that represents fourteen percent of the budget. But if the bidding war hypothesis is that the spouse is forced to work in order to pay for housing expenses, the fact that the family incurs $9,670 in new child car expenses in order to pay $3,690 in new housing expenses is inconsistent with the hypothesis. *The Two-Income Trap* focuses on the reduction in discretionary income between the two periods, but the culprit for this appears to be increased taxes and child care expenses, not increased housing expenses. Moreover, unlike new taxes and child care expenses, increases in the cost of housing and automobiles are offset by increases in the value of real and personal property as household assets that are acquired in exchange. In short, even though the debt obligation associated with housing has increased in recent years, it is not clear that the "bidding war" hypothesis is consistent with either economic theory or available empirical evidence.

Moreover, data from the Federal Reserve on the mortgage debt service ratio also fails to find any major or consistent upward trend that supports the "bidding war" hypothesis. Like the debt-service ratio presented above, the mortgage debt service ratio is the percentage of monthly income dedicated to mortgage debt service. Over the past twenty years the mortgage debt service ratio has hovered within a narrow range between

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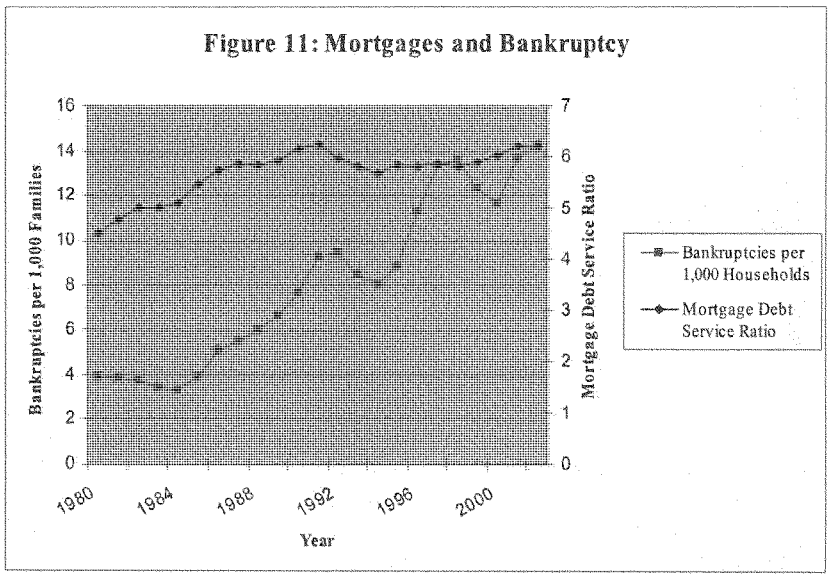
5.01 and 6.35 percent of monthly income, rising from 1982 until 1991, then falling back off before rising slightly above 6 percent again in 2000, as shown in Figure 11:



Source: Federal Reserve Board and Figure 3

Thus, the mortgage debt service ratio has increased, but only slightly—a little over one percent of income—which is certainly not enough to explain the increase in bankruptcies. In addition, default rates on mortgages have remained fairly constant for many years. Moreover, while both the debt service ratio and financial obligations ratio has been constant for homeowners during this period, it is *renters*, not homeowners, who have experienced an increase in their financial obligations. On average, renters spend 17 percent of their total after-tax income on rent payments, more than twice as much in percentage terms than homeowners. If anything, therefore, the financial condition of homeowners has improved dramatically relative to that of renters during the past decade.

Unemployment and Bankruptcy

It has also been argued that factors such as unemployment has led to increased bankruptcy filings. This claim is not sustained by the evidence:

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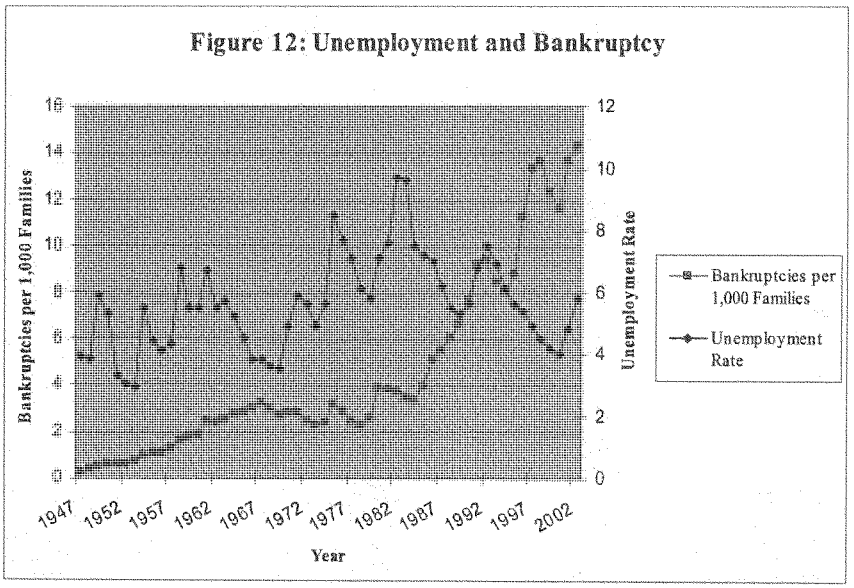

Divorce and Bankruptcy

Nor do trends in divorce rates appear to explain the bankruptcy crisis:

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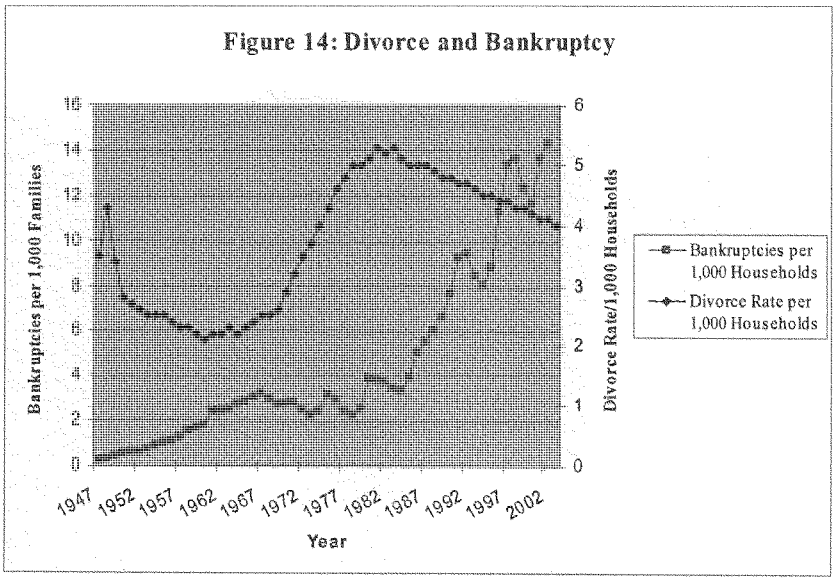

Alternative Explanations

It thus appears that the surge in consumer bankruptcy filings cannot be explained by a rise in household financial distress. What then explains the dramatic rise in bankruptcy filings during the past twenty-five years?

Two identifiable factors present themselves as explaining the rise in consumer bankruptcy filings in recent decades. First is a general decline in the personal shame and social stigma associated with bankruptcy. Second is a change in the relative costs and benefits associated with filing bankruptcy.

There is also little question that the social stigma associated with filing bankruptcy has declined over time. A few years ago, singer Toni Braxton filed bankruptcy, despite having recorded two albums that had earned $170 million in sales at the time, and despite owning a baby grand piano, a Porsche, and Lexus. She later appeared on Oprah Winfrey, who questioned Toni on her purchase of $1,000 in Gucci silverware shortly before filing bankruptcy. Toni's response: "I only spent about $1,000 on it. If *that* made me broke, then I was truly in bad shape. It's Gucci—I love it. I'd buy it again. And now that I get a huge discount because I've given them so much pub, I can *really* shop." This attitude, of course, is not limited to pop music stars, as evidenced by the comments of one individual to CNNfn, "When I found out—this was watching it on the news, in the newspapers—that more and more people are doing it [filing bankruptcy], and . . . it's not just a middle class you know, upper class too—rich people—everybody's doing it. And . . . I said: Why not me? You know, I'm just one more of them." Indeed, several scholars have attributed the rise in consumer bankruptcy filings to a decline in the

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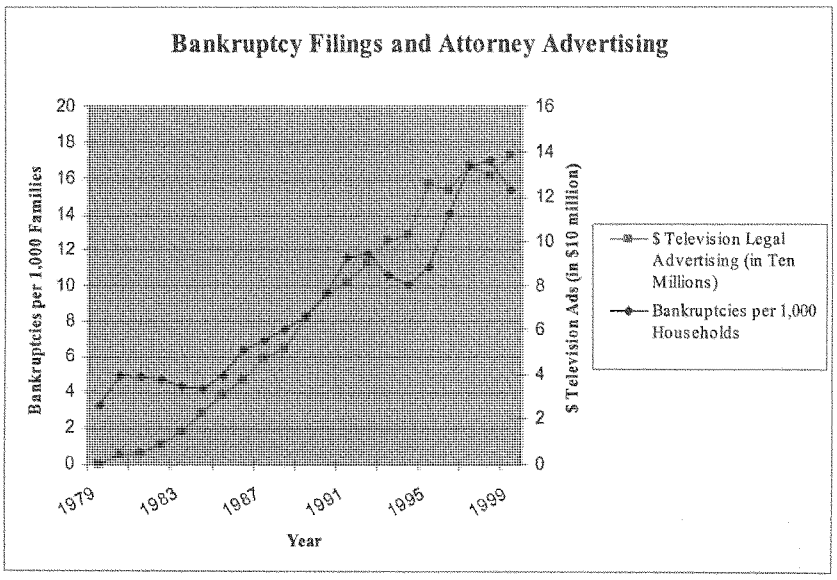
traditional social "stigma" associated with filing bankruptcy. A review and summary of many of these articles can be found in, Gordon Bermant, *What's Stigma Got to Do with It?*, ABI JOURNAL 22 (July/August 2003)

Moreover, the excessive generosity of the current American bankruptcy system has also spurred more bankruptcy filings. It has been estimated that one-third of Americans would benefit financially from filing bankruptcy after engaging in some basic pre-bankruptcy planning. Moreover, because of the structure of property exemptions under bankruptcy and state law, wealthier individuals gain the greatest benefits from filing bankruptcy because they can protect larger amounts of property in bankruptcy. Given the financial benefits created by the enactment of the 1978 Code, it is little wonder that consumers have increasingly recognized and acted on the financial benefits of filing bankruptcy.

At the same time, the costs of learning about and filing bankruptcy have decreased dramatically. Daytime television and the Yellow Pages are awash in bankruptcy advertisements. The mass production of bankruptcy petitions by bankruptcy lawyers have driven down prices for bankruptcy services. In fact, scholars have reported that one of the most difficult tasks confronting lawyers is persuading their clients that there really is no catch to filing bankruptcy, because clients routinely object that the whole things sounds "too good to be true."

The role of attorney advertising and decreasing costs of learning about bankruptcy may be illustrated by the following chart:



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As this chart indicates, there appears to be a very strong correlation between attorney advertising and consumer bankruptcy filings. Of course, there are limitations to the inferences that can be drawn from this chart. The chart measures all advertising, not just bankruptcy advertising. Moreover, it is focused purely on television advertising and ignores other sources of advertising. Nonetheless, attorney advertising for bankruptcy services seems to comprise a substantial portion of attorney advertising in general, and may comprise even a larger percentage of advertising in non-television outlets, such as Yellow Pages, newspaper, Internet, and radio advertising.

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