



No. 3

February 28, 2005

## **S. 256 — The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

Calendar No. 14

*Reported favorably by the Judiciary Committee on February 17, 2005 and placed on the Senate Legislative Calendar under General Orders. A Committee Report has not yet been filed and is not expected to be available by the beginning of floor consideration of this bill.*

### **Noteworthy**

- By unanimous consent, the Senate will proceed to the consideration of S. 256 on February 28 at 2:00 p.m. Consideration on February 28 will be limited to debate only. There is no time agreement, nor has any agreement been reached as to amendments.
- S. 256 was reported favorably by the Judiciary Committee on February 17, with five Democrat-sponsored amendments that were accepted by acting Chairman Hatch.
- S. 256 is very similar to H.R. 975 of the 108<sup>th</sup> Congress, which the House passed on March 19, 2003, by a vote of 315-113. The Senate did not act on H.R. 975 or any comprehensive bankruptcy reform legislation in the 108<sup>th</sup> Congress.
- Both houses of Congress passed bankruptcy reform legislation in the 105<sup>th</sup>, 106<sup>th</sup>, and 107<sup>th</sup> Congresses. President Clinton pocket vetoed an earlier version of this bill in December 2000.
- Bankruptcy filings have been growing rapidly since Congress passed a bill creating the modern bankruptcy regime in 1978. From 1983 to 2003, bankruptcy filings have increased 500 percent.
- S. 256 is intended to reduce the abuse of the current bankruptcy system, primarily through the creation of “needs-based bankruptcy relief” that would require a bankruptcy court to, in some cases, force an individual with means to repay more of his or her debt than the current law requires (i.e., to file under Chapter 13 rather than under Chapter 7).
- More than 50 amendments were filed in the Judiciary Committee, almost all of them from Democrats. Additional amendments are expected on the floor.

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## **Background**

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*Although S. 256 addresses both consumer and business bankruptcies, the primary purpose of the legislation is to curb abuses in the consumer bankruptcy system. The business bankruptcy provisions of the bill, discussed below in the Bill Provisions section, are aimed at fixing loopholes and ensuring that the system works more efficiently. Most of the controversy has centered on the individual bankruptcy provisions, so this background section focuses on those reform efforts.*

**The Modern Bankruptcy Regime for Individual Filers.** Congress crafted the modern bankruptcy regime in 1978. For individuals, Congress developed two primary kinds of bankruptcy, Chapter 7 and Chapter 13. Under Chapter 7, an individual surrenders unprotected assets, allows them to be sold to satisfy (to the extent possible) unsecured creditors, and then is permitted to have the remaining unsecured debt discharged. The Chapter 7 filer can then embark on a “fresh start.” Under Chapter 13, the individual debtor works with the bankruptcy court and creditors to craft a payment plan to satisfy as much of the outstanding debts as possible based on the debtor’s income. Chapter 13 filers do not get an automatic “fresh start” but they also do not have to sell assets or face the social stigma of having defaulted completely on their obligations.

**The Ongoing Increase in Individual Filings.** Soon after the 1978 reforms were enacted, individual bankruptcy filings began to grow rapidly. Most were of the Chapter 7 variety, with few debtors choosing to develop long-term payment plans. Congress passed a revision to the law in 1984 with an aim to forcing debtors who *could* pay back their debts to use Chapter 13, but that legislation proved ineffective at slowing the growth of consumer bankruptcies. As law professor Todd Zywicki recently testified before the Senate Judiciary Committee:

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 years earlier.<sup>1</sup>

For the twelve-month period ending September 30, 2004, individuals filed nearly 1.6 million bankruptcies.<sup>2</sup>

Moreover, this growth in bankruptcy filings does not appear to have any connection with economic conditions in the nation. As Prof. Zywicki explained, “Although the American economy set new records [during the 1980s and 1990s] for economic growth, low unemployment, and low interest rates, this was matched by record-high bankruptcy filings as well.”<sup>3</sup> Indeed, during the time that bankruptcies were growing so rapidly, real median family income increased by more than 15 percent and overall Gross Domestic Product more than tripled.<sup>4</sup>

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<sup>1</sup> Written Testimony of Prof. Todd Zywicki, Senate Judiciary Committee, Feb. 10, 2005 (relying on data from Administrative Office of U.S. Courts).

<sup>2</sup> Administrative Office of the U.S. Courts, Table F-2, “U.S. Bankruptcy Courts, Business and Nonbusiness Bankruptcy Cases Commenced, by Chapter of the Bankruptcy Code, During the Twelve Month Period Ended Sept. 30, 2004,” available at [http://www.uscourts.gov/Press\\_Releases/bankrupt\\_f2table\\_sep2004.xls](http://www.uscourts.gov/Press_Releases/bankrupt_f2table_sep2004.xls) (last checked Feb. 27, 2005).

<sup>3</sup> Zywicki Testimony.

<sup>4</sup> Statistical Abstract of the United States for 2004, Table #674 (income) and Table #641 (GDP), available at <http://www.census.gov/prod/www/statistical-abstract-04.html> (last checked Feb. 27, 2005).

**The Social Costs of Increased Bankruptcies.** The costs of rising bankruptcies to consumer well-being are many, and have been characterized by some as a “bankruptcy tax” that all consumers pay in their daily lives. The most obvious manifestation of the bankruptcy tax is higher interest rates charged by consumer credit providers who must compensate for losses due to default by other borrowers. But the costs also extend to other aspects of the credit system, such as higher down-payment requirements for auto loans, shorter grace periods for paying bills, and higher penalty fees and late charges.<sup>5</sup> For example, the National Credit Union Administration estimates that 2004 bankruptcy filings for credit union members will be 40-percent higher than in 2000, and that more than 40 percent of credit union losses in 2004 will be bankruptcy-related.<sup>6</sup> Those losses must be absorbed by credit union members through lower dividends, fewer member services, and less attractive programs. Finally, consumers suffer when medical bills are discharged in bankruptcy, as doctors and hospitals are then forced to cut back on services or raise prices to compensate for the defaults of other patients. And the individuals hurt most by this “bankruptcy tax” are those who need credit the most — lower-income families that need access to credit for unexpected expenses but who face higher overall borrowing costs in part as a result of others’ bankruptcies.

**The Means Test.** From the standpoint of consumer bankruptcy reform, the primary purpose of this legislation is to restore personal responsibility and the integrity of the bankruptcy system by ensuring that those who truly need complete bankruptcy protection receive it, while those who could pay back their debts live up to their obligations. Thus, S. 256’s primary reform is the creation of a formal “means test” to sort bankruptcy filers into two categories: those who will not be able to pay their debts and who therefore need Chapter 7 protection, and those who should be able to pay at least a portion of their debts and who therefore belong either in Chapter 13 or out of the bankruptcy system altogether.

In simple terms, the means test requires the bankruptcy court to examine the debtor’s Chapter 7 filing and determine whether the filing should be dismissed for abuse of the system or converted to a Chapter 13 repayment plan. *First*, the bankruptcy court determines whether the debtor earns less than the state median income. If the income is below the state median, then the debtor automatically remains in Chapter 7. (It is believed that 80 percent of Chapter 7 filers earn less than the state median income.) *Second*, for those earning more than the state median income, the court deducts secured obligations, other expenses, and additional allowable amounts before applying a formula provided in S. 256 to determine whether the debtor still has the ability to repay at least a portion of his debts. *Third*, even for those debtors for whom sufficient income exists to create a presumption of abuse, those debtors have the opportunity to rebut that presumption by showing special and unique expenses that demonstrate a need for Chapter 7 protection.

The means test is therefore targeted at a narrow group of individuals — only about 7-10 percent of bankruptcy filers<sup>7</sup> — who have above-average income and the means to pay back their debt. Yet even if the means test “only” identifies 100,000-150,000 abusive filings, experts estimate that approximately \$3 billion will be recovered and passed through to other consumers.<sup>8</sup>

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<sup>5</sup> Zywicki Testimony.

<sup>6</sup> Written Testimony of Kenneth Beine, President & CEO of Shoreline Credit Union, Senate Judiciary Committee, February 10, 2005 (citing NCUA data).

<sup>7</sup> Zywicki Testimony.

<sup>8</sup> Zywicki Testimony.

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## **Bill Provisions**

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*A current Committee Report from the Senate Judiciary Committee was not available during the preparation of this Legislative Notice, although the Committee has indicated an intention to complete one. However, H.R. 975 from the 108<sup>th</sup> Congress was nearly identical to S. 256, and the House Judiciary Committee did produce a Committee Report (H. Rept. 108-40) for that bill. Page citations below are to that report.*

### **Title I: Needs-Based Bankruptcy**

Title I implements the primary thrust of S. 256 — the creation of “needs-based bankruptcy relief.” This Title permits the bankruptcy court to either dismiss or convert a Chapter 7 liquidation to a Chapter 13 plan where the court finds “abuse” of the Bankruptcy Code (“the Code”) (versus the current “substantial abuse” standard). It also creates a presumption that abuse exists if the debtor’s income (after allowable expenses) exceeds an amount set by a statutory formula, and only allows that presumption to be rebutted through detailed documentation demonstrating special circumstances. *This “means test” does not apply, however, to any debtor whose income falls below the median income for his or her state, or where the debtor’s income falls below a particular monetary threshold and where the debtor’s spouse’s income should not be attributed to the debtor due to separation.* The “means test” is described in detail at Section 102(a) of S. 256 and at H. Rept. 108-40, at 156-160.

Title I also contains provisions aimed at ensuring that the “means test” is fairly and promptly applied. In addition, all individual debtors seeking to file bankruptcy will be required to receive budget and credit counseling. See H. Rept. 108-40, at 156-165.

### **Title II: Enhanced Consumer Protection**

Subtitle A: Enables court to reduce unsecured consumer debts (typically credit card debts) by up to 20 percent if the debtor can show that the creditor filing a claim unreasonably refused to negotiate a reasonable alternative repayment schedule proposed by an approved credit-counseling agency acting on debtor’s behalf. Enhances enforcement against misconduct by creditors (§§ 202-205). See H. Rept. 108-40, at 165-167.

Subtitle B: Places certain unsecured claims for domestic support obligations in the first priority claim category. Revamps guidelines governing nondischargeability of certain debts for alimony, maintenance, and support. Otherwise frustrates ability of debtor to avoid domestic support obligations via the bankruptcy process. See H. Rept. 108-40, at 167-171.

Subtitle C: Adds additional consumer-protection provisions. Provides some protection for certain retirement and educational IRA funds. Places restrictions on debt relief agency practices. Adds privacy protections. See H. Rept. 108-40, at 171-177.

### **Title III: Discouraging Bankruptcy Abuse**

Title III contains a significant number of provisions aimed at discouraging bankruptcy abuse. For complete explanations of each see, e.g., H. Rept. 108-40, at 177-191. Some of the major provisions are outlined below.

Section 302 creates a presumption that a filing is made in good faith if made within one year of a previous bankruptcy (and where other detailed conditions are met). This presumption can be rebutted with clear and convincing evidence.

Section 303 enables creditors secured by real property to seek relief from automatic stays where the bankruptcy filing was associated with an effort to transfer the secured property or file multiple bankruptcies affecting the same property.

Section 304 makes it more difficult for debtors to retain possession of personal property securing a purchase-money-security interest.

Section 305 provides relief from the automatic stay where the debtor does not complete an intended surrender of consumer-debt collateral.

Sections 306 and 309 increase secured creditors' protections during a bankruptcy process.

Section 307 increases the domiciliary requirements for debtors before they can take advantage of states' exemptions (e.g., homesteads).

Section 308 limits homestead exemptions to the extent that the added value was acquired with the intent to hinder, delay, or defraud a creditor.

Section 310 changes the presumption of nondischargeability for luxury goods. As amended, the presumption will apply if the aggregate amount of consumer debts for luxury goods or services is more than \$500 in the previous 90 days, and, with respect to cash advances, if they aggregate to at least \$750 and are incurred within 70 days.

Section 311 excepts from the automatic stay a judgment of eviction for residential leaseholds where a judgment for possession has been issued prior to the filing of bankruptcy. This section also gives real estate tenants a reasonable amount of time after filing a petition for bankruptcy to cure a default which gave rise to a judgment of possession under certain circumstances.

Section 312 extends the period from 6 to 8 years before which a Chapter 7 debtor can receive a subsequent Chapter 7 discharge.

Section 313 defines "household goods" for the purpose of bankruptcy and caps the exclusions for electronic entertainment equipment, antiques, and jewelry.

Section 314 makes a debt incurred to pay a nondischargeable tax owed to a government unit (other than the U.S. Government) itself nondischargeable. The section also makes nondischargeable other sources of debt detailed in the section. In particular, section 314(b) makes nondischargeable debts for restitution or damages awarded in a civil action against the debtor as a result of willful or malicious conduct by the debtor that caused personal injury to an individual or the death of an individual.

Section 315 adjusts notice requirements to ensure that creditors receive actual notice of bankruptcy filings.

Section 316 requires debtors to promptly file schedules and other required information, or else their cases can be automatically dismissed.

Section 317 ensures that debtors and creditors have ample time to prepare for a Chapter 13 confirmation hearing.

Section 318 requires all Chapter 13 payment plans to extend for a period of not less than 5 years if the debtor's monthly income exceeds certain statutory thresholds.

Section 319 is a sense of Congress regarding the need to change the Bankruptcy Code so that all filings are required to be grounded in fact.

Section 320 provides for prompt relief from the automatic stay in a Chapter 7, Chapter 11 (business reorganization), or Chapter 13 case if certain procedures are followed.

Section 321 creates a new chapter 11 provision for cases filed by individuals.

Section 322 limits the homestead exemption to \$125,000 under certain circumstances. See H. Rpt. at 188-189 for details.

Section 323 excludes an employee benefit plan from "property" for bankruptcy purposes.

Section 327 requires assets to be valued at actual worth, without regard to selling or marketing costs.

Section 328 makes changes to trustees' obligations to cure real property leasehold defaults due to nonmonetary obligations.

Section 331 (added in the Senate Judiciary Committee during markup in the 109<sup>th</sup> Congress) amends Chapter 11 to limit the ability of businesses in bankruptcy to pay executive bonuses.

#### **Title IV: General and Small Business Bankruptcy Provisions**

Subtitle A: This subtitle generally addresses business bankruptcy provisions of the bankruptcy code. It changes the procedural treatment of investors, treatment of executory contracts and unexpired leases, composition of creditor and equity security holder committees, procedures governing preferential transfers, creditor representation, election of trustees, and miscellaneous other provisions. For more information, see H. Rept. 108-40, at 191-195.

Subtitle B: This subtitle addresses "small business bankruptcy provisions." It provides flexible rules for the disclosure statement and reorganization plan (section 431); redefines a "small business case" for the purposes of the Code (section 432); mandates creation of standardized statements and forms for small business bankruptcies (section 433); mandates uniform national reporting requirements regarding the small business's operations (section 434); requires creation of uniform forms and rules to facilitate the reporting described in section 434 (section 435); increases administrative oversight and control of small business bankruptcies through detailed filing and review requirements (section 436); imposes deadlines to ensure that small business bankruptcies are processed promptly (sections 437, 438); imposes additional duties on trustees with regard to small business debtors (section 439); requires bankruptcy courts to hold status conferences so that cases

progress expeditiously (section 440); provides exceptions to the automatic stay for certain cases involving prior bankruptcies (section 441); increases the power of bankruptcy courts to dismiss certain small business bankruptcies, (section 442); directs greater administrative study of small business bankruptcies (section 443); changes the rules governing payment of interest obligations by single-asset-real-estate debtors (section 444); adds a new administrative expense priority for some nonresidential real property leases (section 445); creates duties for debtors who are administrators of employee benefit plans (section 446); and forces trustees to appoint members to a committee of retired employees (section 447). For more information, see H. Rept. 108-40, at 195-200.

#### **Title V: Municipal Bankruptcy Provisions**

This Title amends the Code to require that certain Code provisions are applicable to Chapter 9 cases. For detailed information, see H. Rept. 108-40, at 201.

#### **Title VI: Bankruptcy Data**

This Title provides for the collection of bankruptcy data from the bankruptcy courts, mandates creation of a uniform process to ensure that collection, and provides for audits of the resulting data. For detailed information, see H. Rept. 108-40, at 201-203.

#### **Title VII: Bankruptcy Tax Provisions**

This Title alters treatment of certain tax liens (section 701); simplifies treatment of certain fuel tax claims (section 702); improves notice to the government of requests for determinations of taxes (section 703); sets guidelines for the interest applicable to tax claims (section 704); clarifies the priority of tax claims in light of tolling periods during time that an offer in compromise is pending (section 705); prohibits the discharge of certain tax claims in Chapter 13 bankruptcies (section 707); prohibits discharge of fraudulent taxes in Chapter 11 (section 708); clarifies rules governing automatic stays and prepetition tax obligations (section 709); addresses periodic payment of taxes in Chapter 11 cases (section 710); prohibits the avoidance of statutory liens (section 711); provides rules governing payment of postpetition tax obligations of businesses in Chapter 11 (section 712); addresses tardily filed priority tax claims (section 713); addresses income-tax returns prepared by tax authorities (section 714); clarifies that an estate is protected if the government does not request an audit of the debtor's tax returns (section 715); requires Chapter 13 debtors to file all tax returns as a condition of confirmation (section 716); mandates disclosure of tax consequences to any Chapter 11 plan (section 717); and includes provisions addressing the setoff of tax refunds (section 718), state and local taxes (section 719), and dismissal for failure to timely file tax returns (section 720). For additional information on these tax provisions, see H. Rept. 108-40, at 203-210.

#### **Title VIII: Ancillary and Other Cross-Border Cases**

This Title adds a new chapter to the Code for transnational bankruptcy cases. The stated aim is to provide greater legal certainty for trade and investment as well as to provide for the fair and efficient administration of cross-border insolvencies. For additional information, see H. Rept. 108-40, at 210-223.

## **Title IX: Financial Contract Provisions**

This Title changes the treatment of certain financial contracts in bankruptcy, including commodities contracts. For additional information, see H. Rept. 108-40, at 223-239.

## **Title X: Protection of Family Farmers**

This Title permanently reenacts Chapter 12, a bankruptcy provision enacted in 1986 to address farm financial difficulties. Of note is the redefinition of a “family farmer” by raising the debt eligibility limit from \$1.5 million to \$3.237 million (section 1004). In addition, section 1007 provides a series of amendments to the Code in order to cover “family fishermen” and their commercial fishing operations. For additional information, see H. Rept. 108-40, at 239-241.

## **Title XI: Health Care and Employee Benefits**

This Title includes provisions to protect the care of patients where related health care organizations are in bankruptcy, as well as to protect the privacy of patients’ records. For additional information, see H. Rept. 108-40, at 241-243.

## **Title XII: Technical Amendments**

This Title includes 35 separate technical amendments, which are described in detail at H. Rept. 108-40, at 243-252.

## **Title XIII: Consumer Credit Disclosure**

This Title addresses matters unrelated to the Bankruptcy Code, in particular by amending the Truth in Lending Act. Section 1301 creates increased disclosure requirements for credit card statements and mandates that credit card companies assist borrowers in determining how long it will take to pay off their credit card balances. Section 1302 requires certain additional disclosures to borrowers buying and refinancing their homes. Section 1303 requires additional disclosures regarding credit card “introductory rates.” Section 1304 extends Truth in Lending requirements to Internet-based credit card solicitations. Section 1305 adds new disclosures related to credit card late fees. Section 1306 prohibits cancellation of credit cards solely due to the borrower’s failure to incur finance charges. Section 1307 requires additional administrative study of debit cards and consumers’ liability for their unauthorized use.

## **Title XIV: Preventing Corporate Bankruptcy Abuse**

This short Title — which was not in H.R. 975 so is therefore not discussed in H. Rept. 108-40 — puts greater restrictions on “fraudulent transfers” to insiders, increases protections for insurance benefits for retired employees, prohibits discharge of debts incurred in violation of securities laws, and requires the appointment of a trustee where there are “reasonable grounds to suspect that current members of the governing body of the debtor, the debtor’s chief executive or chief financial officer, or [other corporate leaders] participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor’s public financial reporting.”

## **Title XV: Effective Date**

This Title provides that the Act shall take effect 180 days from enactment unless otherwise specified in the Act.

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## **Administration Position**

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At press time, the Administration has not issued a Statement of Administration Policy (“SAP”) for S. 256. However, the President released a SAP for H.R. 975 in the 108<sup>th</sup> Congress, which read (in full):

The Administration supports the package of bankruptcy reforms reflected in H.R. 975. These common sense reforms will help curb abuses of bankruptcy protections, reduce uncertainty in financial markets through improved financial contract netting rules, increase financial education to prevent unnecessary filings and help avoid future credit problems, and promote international trade through coordination of cross-border insolvency cases.

Statement of Administration Policy, H.R. 975, March 19, 2003.

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## **Other Views**

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Primarily, opponents charge that S. 256 inadequately addresses the causes of consumer bankruptcy. Democrat opponents explained in H. Rept. 108-40 that more attention should be placed on purported “root causes” of bankruptcy, such as “unexpected medical costs, family crises like divorce, loss of high paying full-time jobs, and most notably, the deregulation of credit card interest rates and the dramatic increase in credit card solicitations and overall consumer debt.”<sup>9</sup> The subtext to these arguments is that individuals who face these kinds of difficulties should be able to file Chapter 7 bankruptcy regardless of whether they have the ability to repay their obligations.

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## **Possible Amendments**

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No formal list of amendments was available as this Legislative Notice was being prepared. More than 50 amendments were filed in the Judiciary Committee when S. 256 was marked up, but it is unclear which of those amendments will be offered on the floor. Anticipated germane amendments could fall into the categories below. *The RPC will release detailed amendment descriptions to Republican Senate offices when amendments are formally offered on the floor.*

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<sup>9</sup> H. Rept. 108-40 (Dissenting Views), at 557-558. Title XIII of S. 246, which contains amendments to the Truth in Lending Act, is a partial response to these kinds of concerns.

**Germane — Schumer FACE Act Amendment.** Senator Schumer may offer an amendment to provide that penalties for violations of the Freedom of Access to Clinic Entrances Act are not dischargeable in bankruptcy. (Courts have consistently held that such fines are already not dischargeable, and nothing in S. 256 reverses this case law.)

**Germane — Amendments to Weaken the Means Test.** Although the means test is likely to reach only 7-10 percent of bankruptcy filers, opponents of the underlying legislation may attempt to weaken through a variety of amendments. Those amendments may be aimed at changing the formula used to determine whether those with above-average incomes can remain in Chapter 7, carving out groups of individuals (e.g., veterans or the elderly) from the means test without regard to their ability to repay their obligations, or granting judges discretion to ignore the means test altogether.

**Germane — Amendments to Weaken Paperwork Requirements.** S. 256 corrects a deficiency in the current system by requiring bankruptcy filers to provide accurate information about their assets and liabilities. Opponents may attempt to amend the bill to weaken filers' obligations to provide accurate information.

**Germane — Amendments to Change Corporate Bankruptcy Law.** S. 256 is aimed primarily at addressing consumer bankruptcy abuses, although it does contain some provisions addressing small business bankruptcies and even fewer addressing larger corporate reorganizations (Chapter 11). Amendments may be filed to change the priority structure of different obligations in Chapter 11 reorganizations.

**Germane — Amendments to Add Banking Law Changes.** S. 256 contains provisions in Title XIII that amend the Truth in Lending Law in some regards. Opponents of the bill may attempt to use this bill as an opportunity to legislate further in the banking arena. Note that the Truth in Lending Act falls under the Banking Committee's jurisdiction.

**Germane — Cornyn Bankruptcy Venue Amendment.** Senator Cornyn filed in the Judiciary Committee an amendment based on his bill, S. 314, the Fairness in Bankruptcy Litigation Act. He did not offer the amendment in Committee but signaled that he may offer it on the floor. The amendment would reform the rules governing venue in bankruptcy cases to combat forum shopping by corporate debtors.

**Non-Germane — Kennedy Minimum Wage Amendment.** Senator Kennedy's spokesman told CQ Today (Feb. 25) that Democrats would propose an amendment raising the wage to \$7.25 an hour over 26 months.