The Next Chapter in Bankruptcy Law: What Does It Mean for Debtors and Creditors?

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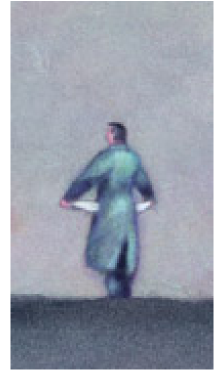

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After years of lobbying, credit card issuers and other business groups got their wish last spring: a bankruptcy law change making it harder for individuals to walk away from their debts. It was a tough fight, with many Democrats and other opponents claiming the law was nothing other than the powerful picking on the poor.

Now, with the law to take effect Oct. 17, some wonder whether it will make much difference to debtors and creditors after all. And although it also modified some corporate bankruptcy rules, those changes seem relatively modest as well.

"I'm curious to see what will happen with this new law," says Wharton finance professor David K. Musto. Although the law's authors want more bankruptcy filers to repay debts, Musto expects courts to find only a small minority able to do so.

The law is designed to force more bankruptcy filers into Chapter 13, which requires that they pay debts on a strict schedule. But, says Wharton finance professor Hulya K. K. Eraslan, it does not address flaws in the Chapter 13 process. "These Chapter 13 repayment plans don't work at all."

The effort to change bankruptcy rules gained momentum in the preceding decade as individual bankruptcy filings doubled to about 1.6 million a year, with an estimated $40 billion in debt forgiven annually. Credit card issuers and other business groups asserted that many filers who were allowed to discharge all of their debts actually could afford to repay at least some of them.

The cause of the rising bankruptcy filings is not certain. Creditors groups tended to blame profligate spending. Their opponents said most bankruptcy filings arose from bad luck, such as job loss, medical expenses or loss of a spouse.

"My view of what caused it is credit cards," says Penn law professor David A. Skeel, who teaches a course on bankruptcy law. "There's a direct cause and effect." Skeel is author of *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton University Press). Before the late 1970s, credit card interest rates were governed by usury laws in card users' home states, he says. Then a U.S. Supreme Court ruling allowed issuers to charge the rates permitted in their state of incorporation. Many issuers incorporated in Delaware and South Dakota, which had higher usury limits, and started marketing their cards nationwide.

As a result, interest rates rose from the 10% range to the high teens. "Allowing credit card companies to charge those rates obviously made it possible for them to give credit cards to people who would not have gotten them before," Skeel says. Issuers and card users are therefore both responsible for excessive borrowing that led to more bankruptcies, he argues.

Loosening credit also changed borrower's attitudes about defaulting. In 1960, a prospective borrower got credit by meeting face-to-face with a bank lending officer. Today, people get credit by responding to junk

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mail. "I just think people look at the credit relationship differently than they did 40 years ago," Skeel says.

Musto and Eraslan also blame rising credit card use for the increase in bankruptcies. Card issuers portray themselves as lenders for emergencies. "But once you have your card they're not policing you," Musto says. As the number of bankruptcies rose, the stigma of filing for bankruptcy fell, he adds. "It's tough to nail down, though it seems to be a piece of what's going on."

The "Means Test"

With Republicans in control in Washington, creditors made the final push that led to passage last spring of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Its chief provision is a "means test" that will apply to filers choosing Chapter 7, which allows discharge of all unsecured debts, rather than Chapter 13, which requires a five-year debt repayment plan. A bankruptcy trustee or creditor will be allowed to petition the court to deny Chapter 7 if the filer has income higher than the median in his or her home state.

In addition, in the absence of undue hardship, debtors will not be allowed to discharge student loans. Debts to a single creditor of more than $500 will not be forgiven if they were incurred within 90 days of the bankruptcy filing. Cash advances of $750 or more received within 70 days of filing also will not be discharged.

Nor will an individual be permitted to file for Chapter 7 more often than once every eight years. Before filing for bankruptcy, an individual will be required to receive a briefing on alternatives, and debtors will be required to take a financial management course after filing.

Once the law takes effect, the key question will be how many people fail the means test and are forced into Chapter 13 rather than Chapter 7, says Skeel. "There aren't many people it's going to directly apply to, because the means test kicks in only for people who are over the median in their state, which is a very small percentage."

Various experts have suggested that only 5% to 10% of bankruptcy filers can repay some of their debts, but Skeel expects the figure will turn out to be even lower.

The means test is a multi-step calculation, and many of the law's opponents focused on language that figured income as an average of the six months preceding filing. Opponents felt this could force some filers into Chapter 13 rather than Chapter 7 even if they no longer had any income.

"Does the law actually force a judge to put someone into 13 when it's obvious that the resources don't exist anymore? It doesn't seem to me that it does," Musto says.

Skeel notes that much continues to be left to the judge's discretion, and that practices vary around the country. Southern courts, for example, have long been more prone to force debtors into repayment plans under Chapter 13. "It's driven so much by the culture of the bankruptcy courthouse," he says. "It's hard to imagine this bill is going to dramatically change that.... I'm not worried about it accidentally pushing people into 13 who shouldn't be."

Even if the law succeeds in shifting more bankruptcies to Chapter 13, card issuers and other reform proponents may find they really don't recover very much, Eraslan says. In a study of 3,000 bankruptcies filed in Delaware during 2001 and 2002, she found that most Chapter 13 filers failed to satisfy their repayment requirements. "Only about 30% of the people make it to the end."

It will take more research to find out why, she adds. It may be that repayment schedules are too

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demanding, so that debtors crumple when faced with a loss of income or an unexpected expense, such as a car repair or medical bill. It's also possible that many filers are simply no good at managing their finances -- the reason they ended up in bankruptcy in the first place.

If either -- or both -- explanations is true, the new filers shifted from Chapter 7 may have the same problems.

Skeel, who is not a fan of the new law, says he would have preferred a simpler one requiring bankruptcy filers to turn over 10% of their after-tax income for debt repayment for a number of years, with no payments for those with no income. This would have been easier to administer and fair to people who really were destitute, while still requiring some debt repayment from those who could manage it.

The new law's complexity, he says, will increase costs borne by filers. Their lawyers, for example, will now be required to attest to the accuracy of financial statements made to the court, adding to their workload. In the past, lawyers weren't held as accountable and tended to take filers' claims at face value. "Now they are going to have to do at least some investigation, and they are going to have to pass that cost on."

He notes that the act tightened rules that in some states let filers keep homes that otherwise could be sold to pay debts. But the changes were relatively modest; wealthy debtors will still be able to shelter large sums in homes in places like Florida and Texas -- because of specific state laws allowing this -- as they have for years.

New Rules for Corporate Bankruptcy

Although the act's main goal was to reform personal bankruptcy rules, it did change some rules on corporate filings. But Skeel says he is not convinced the changes were needed. The corporate-bankruptcy system has long been very effective, he suggests.

Previously, a company that filed for bankruptcy protection could remain under the control of its managers -- the "debtor in possession" -- indefinitely. Under the new rules, the company will have the exclusive right to plan the reorganization for only 180 to 210 days. After that, creditors will be able to propose plans of their own. Skeel says critics are rightly concerned that in some cases certain creditors will stall a company's reorganization so that they can propose one that favors them over other creditors.

Another provision will make it tougher for bankrupt companies to wriggle free of leases. This could make reorganization more difficult for retailers, though Skeel doesn't think this will be as big a problem as many of the law's critics do.

The act also makes it harder for companies in bankruptcy to pay bonuses to managers. That was mainly intended to prevent corporate crooks from continuing to plunder their companies in bankruptcy.

But Skeel argues these cases are rare. Most corporate bankruptcies do not involve fraud, and in those that do the crooks are usually gone by the time bankruptcy is filed. Managers who take companies out of bankruptcy have long been compensated primarily with performance-based bonuses, and that system has worked well, Skeel says. After the law takes effect, it will be important to see whether talented managers will stay through reorganizations without bonuses. "It seems pretty clear that when Congress put this provision in, it was not thinking about this."

The Final Verdict?

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Judging the effectiveness of the personal-bankruptcy changes will not be easy, both Skeel and Musto say. It will take many months, and perhaps years, to evaluate the results.

According to Musto, Chapter 13 is an unpleasant process, with filers placed under court control and forced to live on a strict monetary diet. Chapter 7 is less harsh. Card issuers and other reform proponents argued that Chapter 7 was so easy to get through that many people who used it would have avoided bankruptcy altogether if they had to use Chapter 13.

If this is so, there may be fewer Chapter 7 filings after the new law takes effect because courts won't allow them, Musto suggests. But there won't be any increase in Chapter 13 filings, because that process is so unpleasant it is used only by people who have no choice, he adds.

Skeel sees it a bit differently. "If this law has the effect that its proponents argue that it should, you would expect to see more Chapter 13 cases," since courts will be forcing Chapter 7 filers into Chapter 13, he says. At the same time, there would be fewer Chapter 7 cases.

On the other hand, it may turn out that there haven't been that many "strategic filers" -- people who could have paid down their debts but didn't because Chapter 7 was so lenient. If these people made up only a small portion of bankruptcy filings, there will be no change in the ratio of Chapter 7s to Chapter 13s. Says Skeel: "I'm a little skeptical as to whether the balance will change."

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