BANKRUPTCY REFORM

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
COMMERCIAL AND ADMINISTRATIVE LAW

OF THE

HOUSE COMMITTEE ON THE JUDICIARY

AND THE

SUBCOMMITTEE ON
ADMINISTRATIVE OVERSIGHT AND THE COURTS

OF THE

SENATE COMMITTEE ON THE JUDICIARY

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BANKRUPTCY REFORM

THURSDAY, MARCH 11, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON COMMERCIAL
AND ADMINISTRATIVE LAW,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in Room 2141, Rayburn House Office Building., Hon. George W. Gekas [chairman of the subcommittee] presiding.

Present: Representatives George W. Gekas, Ed Bryant, Steve Chabot, Asa Hutchinson, Jerrold Nadler, Tammy Baldwin, Anthony D. Weiner, and William D. Delahunt, and Senators Charles E. Grassley and Christopher J. Dodd.

Also present: Congressman Nick Smith of Michigan and Senator Joseph Biden, Jr.

Staff present: Raymond V. Smietanka, Subcommittee Chief Counsel; Peter Levinson, Full Committee Counsel; Susan Jensen-Conklin, Subcommittee Counsel; Audray Clement, Subcommittee Staff Assistant; David Lachmann, Minority Professional Staff Member; Perry Apelbaum, Minority General Counsel, and Julian Epstein, Minority Chief Counsel and Staff Director.

OPENING STATEMENT OF CHAIRMAN GEKAS

Mr. GEKAS. [presiding.] The hour of two o'clock having arrived, this extraordinary session of the Judiciary Subcommittee on Commercial and Administrative Law will come to order.

It is extraordinary in several different aspects, not the least of which is that it is and will become a bicameral joint session for the first time in several generations, as we have been told.

Thus, we make our imprint on history right at the outset. The plans for the day are going to be altered somewhat, through no fault of our own, in that the Senate of the United States is engaged in a series of votes, which are stacked, one after another. And our Senators, who will be participating in this hearing, are sharing the time between this chamber and that of their own. And so we will expect them to walk in and out throughout the whole entire process.

But in the meantime, we are going to, even though we lack a quorum for the purposes of a hearing on the House side, we are going to entertain now an opening statement by Senator Grassley, who is not bound by the House rules. And he reminds me of that quite often. So we now welcome to our chamber and introduce to you, Senator Grassley, who has been a monumental leader in the

world of bankruptcy and, particularly, in his efforts in the last Congress and the ones that have so famously begun now in this session of Congress. He is, whether he knows it or not, whether he will acknowledge it or not, an expert in this field. And he has proved, especially during the conference wrangling of last year, his ability to put various elements together and to allow us to emerge with a saleable product, which was the conference report of the last session.

With that, I allow or I switch the microphone to Senator Grassley so that he may address our gathering.

[The prepared statement of Mr. Gekas follows:]

PREPARED STATEMENT OF HON. GEORGE W. GEKAS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF PENNSYLVANIA, AND CHAIRMAN, SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW

A hearty welcome to Chairman Grassley and our colleagues from the other body. Chairman Grassley is to be commended for his tireless leadership and hard work on behalf of bankruptcy reform.

Today is truly a most auspicious occasion for several reasons. First, it marks what may very well be a historical occasion—a bicameral hearing on bankruptcy reform. Second, it brings to full circle the bicameral efforts that culminated in the last session in the conference report on H.R. 3150, the Bankruptcy Reform Act of 1998. In fact, the bill that I introduced last month is identical to the conference report.

Third, this hearing marks more than four years of careful analysis and review of our nation's current bankruptcy system—a review that began with the creation of the National Bankruptcy Review Commission back in 1994. The Commission then spent two years studying our bankruptcy laws and produced a report with numerous recommendations, many of which are memorialized in my bill.

Today's hearing on bankruptcy reform is the first of a series of four that my Subcommittee will hold on the subject of bankruptcy reform. Over the course of these hearings, it is anticipated that we will hear from more than 50 witnesses, representing nearly every major viewpoint on bankruptcy reform. These hearings complement the extensive series of hearings that the Subcommittee held last year, during which more than 60 witnesses testified.

Like last year, it is important to note that I have made every effort to ensure that these hearings are fulsome and inclusive of divergent views. To that end, I actively solicited recommendations from our minority colleagues with respect to witnesses who represent a broad cross-section of viewpoints. In fact, there are several witnesses that I have invited who ardently oppose my views of bankruptcy reform.

To further ensure bipartisan involvement, we have invited our colleagues and their staffs to several press conferences and briefings on important issues dealing with the treatment of child support and needs-based bankruptcy relief.

And these efforts will continue. We hope, in the near future, to hold a comprehensive bipartisan briefing on my bill, H.R. 833, and the bill that Mr. Nadler is reportedly preparing to introduce shortly. The purpose of this briefing will be to assist Members and their staff in their understanding of both bills as we undertake their consideration.

In the midst of economic well-being, we continue to be shocked by the ever-escalating rate of bankruptcy filings, which last year topped 1.4 million. These statistics evidence that there is an overwhelming need for comprehensive reform, not just some tinkering or minor refinement of the current system.

Our mandate is clear and unequivocal: to reduce abuse and restore public confidence in the integrity of the bankruptcy system. It is my sincere hope that we can work cooperatively to achieve these goals.

Mr. GRASSLEY. Well, most importantly, not only to acknowledge your leadership for this meeting and to echo what you said about me, but to say the same thing about you in the last Congress. Because of your leadership, moving such a comprehensive bill through the House of Representatives by such a wide bipartisan margin made possible our moving a bill through the Senate.

I thank you very much for your leadership, and, once again, acknowledge a close working relationship, not only during the last

Congress, but particularly as the last Congress ended and extending into this Congress. I thank you very much for the sort of communication we have had that have been able to move a bill in a more parallel fashion this time as opposed to last time. Although in the final analysis, things worked out fairly well as far as our compromise was concerned, but we started out at very different points.

So I acknowledge that, and thank you once again. And I look forward to that close working relationship hopefully over just the next few months as opposed to the next several months to get something to the President of the United States. And I would apologize for not only myself by my colleagues that we do have these nine votes coming up, and it will probably preempt almost any involvement in this hearing beyond my statement.

I would say to you that if we do get done soon, and you are still going, I intend to come back after the Senate's complete. So thank you for that. And I know that we have an Iowan testifying today, so it is my privilege also to welcome Mr. Larry Nuss from Cedar Falls—head of a credit union that I used to belong to when I was a factory worker in Cedar Falls, Iowa. And I am glad that he is coming to give some Iowa common-sense approach to the bankruptcy issue.

The Library of Congress tells me that this is the first joint hearing on bankruptcy reform since 1932. With today's scheduling problems, I think that I understand why because this is an historic moment, and we should all recognize it as such.

I think that the need for real bankruptcy reform is pretty obvious. You don't need an army of scientists or law professors or anybody else from academia or outside to tell us that we have a serious bankruptcy problem. These are good times in America. Thanks to hard work of our Congress, we have the first balanced budget in a generation, and that came since Republicans took over the Congress. As a result, unemployment is low. We have a solid stock market. And most Americans are optimistic about the future.

Despite the successes I just cited, we still need to shape up our economy. Our taxes are too high. Our bankruptcy system needs to be fixed. About one and one-half million Americans will declare bankruptcy this year if previous trends continue.

Since 1990, the rate of personal bankruptcy filings are up an amazing 94.7 percent. That's almost 100 percent increase in bankruptcies—and all during a time of very high prosperity.

Of course, bankruptcy and taxes are linked, since consumers who pay their own way are penalized by having to pick the tab for irresponsible bankrupts who walk away from debt.

Over 30 years ago, Senator Albert Gore, Senior, described this connection between tax burdens and bankruptcies on the Senate floor. He said that chapter 7 is like a special interest tax loophole. Like tax loopholes, chapter 7 allows someone to get out of paying his fair share and to shift costs to the hard working Americans who play by these rules.

I think that Senator Gore had it exactly right. Bankruptcy reform is all about closing loopholes so well-to-do scoundrels can't get out of paying their fair share.

In the last Congress, we almost closed the chapter 7 loophole. The Senate and the House both passed good bills, and we made them both better in conference that received overwhelming bipartisan support.

In the conference report, we have a means testing with an overlay of judicial discretion. We have new consumer protections, and I think that is why the conference report received such overwhelming support in the House of Representatives last Congress.

In my view, last year's conference report is a good starting point. With some modifications, I think it is a package that will continue to have broad bipartisan support. I have been working with Senator Torricelli, my ranking member, and his staff on this basis, and I think that things are going well.

I want to close with a quote on the need of bankruptcy reform. "I realize that we cannot legislate morals. But we, as responsible legislators, must bear the responsibility of writing laws which discourage immorality and encourage morality; which honesty and discourage deadbeating; which make the path of social malingering and shirker sufficiently unpleasant to persuade him"—and a I can say parenthetically or her—"at least to investigate the ways of an honest person."

Now, who do you think said that? Some cold-hearted conservative? Some Republican spindoctor? No, that was Senator Albert Gore, Senior, the Vice President's father. He said that on January the 19th, as we was introducing at that time a bill that was called S. 613, to impose a means test on chapter 7 bankrupts. My point is that the need to tighten up bankruptcy laws in a meaningful way has deep roots on both sides of the aisle. And it is based on common sense.

Last year, we came very close. This year, I hope that we can work together on the people's business and get meaningful bankruptcy reform finally done and to the President for his signature. Thank you very much.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

At the outset, Mr. Gekas, I want to apologize for the votes in the Senate which have prevented me from being here or being more involved in this hearing. I know we have an Iowan testifying today. I'm certain that Mr. Larry Nuss from Cedar Falls, Iowa will grace this joint hearing with some good Iowa common-sense.

The Library of Congress tells me that this is the first joint hearing on bankruptcy reform since 1932. With today's scheduling problems, I think I understand why. But this is an historical moment and we should all recognize it as such.

I think that the need for real bankruptcy reform is pretty obvious. You don't need an army of so-called scientists, law professors and pointy-heads to tell us that we have a serious bankruptcy problem.

These are good times in America. Thanks to the hard work of a Republican Congress, we have the first balanced budget in a generation. Unemployment is low, we have a solid stock market and most Americans are optimistic about the future.

Despite the successes I just cited, we still need to shape up our economy. Our taxes are too high and our bankruptcy system needs to be fixed. About one and a half million Americans will declare bankruptcy this year if previous trends continue. Since 1990 the rate of personal bankruptcy filings are up an amazing 94.7 percent. That's almost a 100% increase in bankruptcies during a time of prosperity.

Of course, bankruptcy and taxes are linked since consumers who pay their own way are penalized by having to pick up the tab for irresponsible bankrupts who walk away from their debts. Over 30 years ago, Senator Albert Gore, Sr. described this connection between tax burdens and bankruptcy on the Senate floor. He said

that chapter 7 is like a special interest tax loophole. Like tax loopholes, chapter 7 allows someone to get out of paying his fair share and shift costs to hardworking Americans who play by the rules.

I think that Senator Gore had it exactly right. Bankruptcy reform is all about closing loopholes so well-to-do scoundrels can get out of paying their fair share.

In the last Congress we almost closed the chapter 7 loophole. The Senate and House both passed good bills, and we made them both better in a conference that received overwhelming bi-partisan support. In the conference report, we have means-testing with an overlay of judicial discretion. We have new consumer protections. And I think that's why the conference report received such overwhelming support in the House of Representatives last Congress.

In my view, last year's conference report is a good starting point. With some modifications, I think it's a package that will continue to have broad bi-partisan support. I have been working with Senator Torricelli, my new Ranking Member, and his staff on this basis and I think that things are going well.

I'll close with this quote on the need for bankruptcy reform:

> *"I realize that we cannot legislate morals, but we, as responsible legislators, must bear the responsibility of writing laws which discourage immorality and encourage morality; which encourage honesty and discourage deadbeating; which make the path of the social malingerer and shirker sufficiently unpleasant to persuade him at least to investigate the way of the honest man."*

Now, who do you think said this? Some cold-hearted conservative? Some Republican spin doctor?

No, Senator Albert Gore, Sr.—the Vice-President's father—said this on January 19, 1965 as he was introducing S. 613 to impose a means-test on chapter 7 bankrupts. My point is that the need to tighten up bankruptcy laws in a meaningful way has deep roots on both sides of the aisle and is based on common sense. Last year we came very close. This year, I hope that we can work together on the people's business and get meaningful bankruptcy reform done.

Mr. GEKAS. We thank the Senator for that statement, and, of course, he has the run of the mill here. He may leave at any time to answer the call of the Senate. In the meantime, we acknowledge the presence of the gentleman from Arkansas, Mr. Hutchinson, and the gentleman from Tennessee, Mr. Bryant, their presence accounting for a hearing quorum for the House of Representatives, thus permitting us to proceed with this hearing.

We also want to acknowledge the visitation by Congressman Smith of Michigan who was the author of and for the impetus providing a short-term extension of chapter 12 until we can deal with it in the comprehensive way we plan to do as part of this bankruptcy reform effort. We can report to him that the Senate seems poised to act on the bill at a propitious stage in their proceedings.

We acknowledge the presence of Senator Dodd. Does the Senator wish to make a 2-minute statement?

We recognize the Senator.

Mr. DODD. I am going to ask unanimous consent, Mr. Chairman, that these remarks be included in the record.

Let me thank you for doing this. I think it is a wonderful idea to have a joint hearing and to invite those of us who were involved in last year's bankruptcy reform effort. I am not a member of the Senate Judiciary Committee. I did, however, sit in this very committee room as a freshman member of the House a number of years ago. As you know, several of us here today were very involved in last year's bankruptcy reform and were responsible for a number of provisions in the Senate adopted legislation, which, as you know, passed 97 to 1, and represents a strong bipartisan commitment to bankruptcy reform.

Clearly, we need to reform the bankruptcy laws. You've been over the statistics, the 400 percent increase in the number of bank-

ruptcies since 1980. The social stigma of going bankrupt appears to be gone—and this is obviously a serious problem.

My statement today, Mr. Chairman, is really an effort to highlight the provisions that the Senate included in its bipartisan bill, a bill that passed the Senate by such an overwhelming majority. I urge you in the House bill—we do not have a Senate bill yet—to include some of these provisions.

For instance, we requested that the credit card companies give a real life example to consumers in their credit card statement. If Senator Dodd or Chairman Gekas have a $3,000 credit card obligation, how long will it take us to pay it off if we pay just the minimum payment on this obligation. We wanted to give consumers a sense of what their obligations are going to be so they act more responsibly when they go into financial arrangements.

Your bill has a hypothetical disclosure using a $500 example. We think it is more instructive for consumers to know exactly what their own obligations are going to be.

We also want to raise our concerns during today's hearing about child support and alimony. Since the turn of the century, we have always prioritized certain creditors and spouses and children have been at the top of the list. We now have $43 billion in child support arrears and $16 billion in current child support due in this country. We do not want to make it more difficult for child support payments to be made. We think that these creditors still need to be protected and the Senate-passed bill had some good, strong, bipartisan language that did just that. We appreciate how helpful Senator Grassley was in helping us to place this language in last year's bill. Again, you are going to hear from a lot of different people today, and I apologize for sort of racing along here this morning, but I don't want to miss the vote in the Senate.

I will leave this testimony for you to take a look at and urge you to consider what would get us closer to a bipartisan proposal in both Chambers on these provisions. I commend you again for holding this hearing today. I am sorry we didn't get bankruptcy reform done last year. It is critically important and necessary legislation.

[The prepared statement of Senator Dodd follows:]

PREPARED STATEMENT OF HON. CHRISTOPHER J. DODD, A U.S. SENATOR FROM THE STATE OF CONNECTICUT

I would like to thank Chairman Gekas, Chairman Grassley, Senator Torricelli and Representative Nadler for scheduling today's hearing on bankruptcy reform.

Clearly, we need to reform our bankruptcy laws. There has been a 400 percent increase in personal bankruptcies since 1980. The most recent statistics from the Administrative Office of the U.S. Courts state that in the year ending June 30, 1998, more than 1.4 million people filed for bankruptcy, an all-time high. This alone represents an 8.5% increase from the previous year.

Senators Hatch, Leahy, Grassley and Durbin worked hard last Congress to craft a strong, bipartisan and balanced bankruptcy reform bill, a bill which passed the Senate overwhelmingly by a 97–1 vote. While not perfect, S. 1301 took into account the interests of both consumers and creditors.

While asking consumers to take more responsibility for their personal debt, S. 1301 also gave consumers access to information that would help them make better financial choices pre-bankruptcy. These principles were agreed to on a bipartisan basis in the Senate. Regrettably, time was short at the end of last session, and a conference report was somewhat hastily concluded. As a result, a number of strong provisions supported by 97 members of the Senate were excluded from the conference report.

One of the consumer protections in the Senate bill was co-authored by me, Senator Sarbanes and Senator Durbin—an important new consumer protection regarding credit card debt. Today, many consumers are unaware of the implications of carrying credit card debt and making only the minimum monthly payment on that debt.

For instance, assume a consumer has $3000 in credit card debt. Then assume the interest rate that the consumer is paying on that debt is 17.5%, which is roughly the industry average. If the consumer makes only the monthly minimum payment on that debt, it will take 396 months or 33 years to pay it off. And with interest, the consumer will have paid a total of $9,658.

Our amendment, which we also worked on with Senators Grassley and Hatch, would have required credit card issuers to inform consumers on their monthly billing statement not only how long it would take them to pay off a debt at the minimum monthly rate, but also how much money they would have paid in interest and principal on that debt. This amendment was based on a simple premise: the better-informed the consumer, the better that consumer's financial decisions will be.

No one can argue with the goal of increasing personal responsibility. However, we need to realize that a carrot sometimes is preferable to a stick: giving consumers more information about the long-term impact of their short-term credit decisions will encourage them to act more responsibly.

The credit disclosure provisions included in the Senate bill last year were balanced and fair. Yet they were replaced in the conference report with provisions that actually could confuse consumers. For instance, instead of the Senate provision requiring credit card issuers to disclose specific information about a consumer's specific debt, the conference report only required a hypothetical disclosure about a hypothetical $500 debt. Such a disclosure would be unhelpful—and maybe even confusing—to a consumer trying to understand the implications of carrying a specific debt with a much larger balance over a longer period of time. This problem is exacerbated if the disclosures are based on a teaser rate of interest rather than the interest rate that actually will be applied to the consumer's charges. Other provisions were replaced with requests for future study by the Federal Reserve. I hope that instead of studies and unhelpful disclosures, bankruptcy reform will contain the meaningful disclosures agreed to by 97 senators last fall.

It is also my hope that we enact bankruptcy reform that properly protects children and families. As you know, for nearly 100 years our bankruptcy laws have adhered to a fundamental principal: that children and their innocent parents—to the extent possible—should not be impoverished by bankruptcy proceedings. Last year, I and others raised some concerns that perhaps this historical balance in favor of children was being shifted somewhat toward creditors.

I worked with Chairman Grassley, Chairman Hatch, Senator Durbin and others to address these concerns. We were largely successful. For instance, we:

1. Protected income from sources legitimately dedicated to the welfare of children, such as child support payments, foster care payments or disability payments from being dissipated and misdirected towards the payment of debts unrelated to the care and maintenance of children;
2. Ensured that in bankruptcy, children and families are able to keep certain household goods which typically have no resale value. I am speaking about items such as toys, swings sets, video cassette recorders or other items used to help them raise their children; and
3. Added provisions that should help children and families collect child support debts such as permitting the conditioning of a chapter 13 confirmation upon the payment of child support payments and allowing the conditioning of a chapter 13 discharge upon the payment of all post-petition child support obligations.

I hope that we can retain these and like provisions in this Congress.

I am aware that the National Partnership for Women and Families, the National Women's Law Center and a variety of other women's organizations continue to object to provisions regarding the non-dischargeability of certain types of unsecured debt in the newly-introduced House bill, H.R. 833. These groups continue to express their concerns that such provisions will impede the ability of debtors to pay both for their post-bankruptcy expenses and to care for their dependents. I hope both the House and Senate subcommittees look into these issues very carefully.

Finally, section 115 of the newly-introduced House bill entitled, "Protection of Savings Earmarked for the Postsecondary Education of Children," appears to be a version of my educational savings amendment from last year's Senate bill. As most of you know, I am a lawyer, and that provision fails, as best I can tell, to provide

the exemption I intended. And it also appears to fail to protect against the commission of fraud. I would encourage appropriate committee staff to meet with members of my staff regarding this particular provision so that we can truly protect duly established college savings accounts, which were set up for the benefit of children, from being distributed to creditors. Just because a child's family has gone through a bankruptcy does not mean a child should not be able to go to college.

Again, I thank you for calling this hearing. I look forward to working with colleagues in both bodies to enact strong and balanced bankruptcy reform that strengthens the responsibilities not just of consumers, but also of creditors, and that protects innocent children from impoverishment.

Mr. GEKAS. Without objection, the statement of the Senator will be included in the record. He can return to the Senate with the assurance that the hearing—this one and the ones to follow, plus the final version of the bill—will address the concerns that he has addressed.

Mr. DODD. Thank you, Chairman, very, very much. Thank you.

Mr. GEKAS. We thank you. The Chair now notes the presence of the gentleman from New York, Mr. Nadler, the ranking member of the committee; the lady from Wisconsin, Ms. Baldwin; and the gentleman from Massachusetts, Mr. Delahunt. Mr. Manager Hutchinson and Mr. Manager Bryant—to revive memories—have already been recorded in their presence. We will begin with hearing from Congressman Sessions, who was going to be joined by Senator Kohl to present the pros and cons of the homestead exemption solution that we arrived at last year. Congressman Sessions has been in the forefront of pressing for bankruptcy reform and, indeed, is a cosponsor of the current legislation. He and Senator Kohl were to be supplying opening statements. Because Senator Kohl is not here, we will instruct staff to inform the Senator's staff that his statement will be made a part of the record, and that we will hear from his opposite number, Congressman Sessions at this juncture.

[The prepared statement of Senator Kohl follows:]

PREPARED STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Thank you, Mr. Chairman. As the number of bankruptcies continues to rise, there is little doubt that we need bankruptcy reform. Last year, I was pleased to support the Senate reform bill, which in my view was a balanced measure that eliminated the worst abuses without overburdening honest debtors. As we consider reform this year, we should continue trying to be both balanced and fair.

One provision that to my mind is *essential* to any meaningful bankruptcy reform is a cap on the homestead exemption. Today, Senator Sessions and I are reintroducing our bipartisan measure to cap the homestead exemption at $100,000. Last year, this proposal was strongly supported in our reform bill, although it was defeated by a very, very narrow margin in the House. We intend to offer it as an amendment to the Senate bill either in Committee or on the floor. I know that Senator Grassley is a longtime supporter of this measure.

Our bipartisan measure closes an inexcusable loophole that allows too many debtors to keep their luxury homes, while their legitimate creditors—like children, ex-spouses owed alimony, state governments, universities, retailers and banks—get left out in the cold.

Currently, a handful of states allow debtors to protect their homes no matter how high their value. And all too often, millionaire debtors take advantage of this loophole by moving to expensive homes in states with unlimited exemptions like Florida and Texas, and declaring bankruptcy—yet continuing to live in a style that is no longer appropriate. Let me give you a few examples:

- The owner of failed Ohio S&L, who was convicted of securities fraud, wrote off most of $300 million in bankruptcy claims, but still held on to the multimillion dollar ranch he bought in Florida.

- A convicted Wall Street financier filed bankruptcy while owing at least $50 million in debts and fines, but still kept his $5 million Florida mansion with 11 bedrooms and 21 bathrooms.
- And last year, movie star Burt Reynolds wrote off over $8 million in debt through bankruptcy, but still held onto his $2.5 million Florida estate.

Now, don't get me wrong. I loved Burt Reynolds in "Smokey and the Bandit." But while the homestead exemption may not be the most common abuse of the bankruptcy system, it *is* the most egregious. If we really want to restore the *stigma* attached to bankruptcy, these high profile abuses are the best place to start.

Chairman Gekas, you should be commended for imposing a two-year residency requirement in your bill, which will prevent people from moving to Florida or Texas solely to take advantage of the exemption. But that only addresses half of the problem: it doesn't stop longtime residents—like Burt Reynolds—from using an unlimited exemption to shortchange honest creditors from their *home states*. That's why I hope this Congress will reconsider including the homestead cap. Because, to my mind, this isn't about states' rights. Anyone who files for bankruptcy is choosing to invoke *federal* law in a *federal* court. It's fair to impose *federal* limits.

A cap is not only the best policy, it also sends the best message. It says that bankruptcy is a tool of last resort, not just a tool for financial planning. And it gives credibility to reform by going after the worst abuses, no matter who is involved. So I hope you will give a homestead cap the full consideration it deserves. Thank you.

Mr. NADLER. Mr. Chairman?

Mr. GEKAS. Yes.

Mr. NADLER. Before Congressman Sessions, what about opening statements?

Mr. GEKAS. I thought that we would accommodate Congressman Sessions.

Mr. NADLER. Do we have the——

Mr. GEKAS. And will right afterwards, we will accommodate the opening statements.

Mr. NADLER. Thank you.

Mr. GEKAS. We did so for Senator Dodd, and we will do it for Congressman Sessions. You may proceed.

Mr. SESSIONS. Mr. Chairman, thank you. I would ask unanimous consent that my entire write-up here, testimony, be considered for inclusion into the record.

Mr. Chairman, thank you for allowing me to be here today. I find it very interesting that my officemate, Mr. Delahunt, the gentleman from Massachusetts is here. He has a great expertise in what I am preparing to discuss today.

Mr. Chairman, that is that I am aware that there is a bill being considered in the Senate which would place a $100,000 homestead cap on the amount that a family is allowed to exempt from bankruptcy laws.

This is not an inconsequential change. This cap on the homestead exemption was seriously debated last year, when the bill reached the floor of the House of Representatives. A bipartisan majority of members voted for an amendment on the floor last year to replace the cap with a provision to prevent the fraudulent use of the homestead exemption. That amendment effectively targeted homestead exemption abuses without hurting honest debtors and also without overriding State laws by removing the exemption in cases of fraudulent conversion of non-exempt assets into exempt homestead property within 1 year of filing for bankruptcy, with the intent to avoid paying creditors.

If the goal is to restrict further fraudulent abuse of our bankruptcy laws, this year's bill goes even further toward that goal by

having a 2-year residency requirement before a debtor can claim the homestead exemption available in a particular State.

This will strengthen current laws by discouraging debtors from what I call carpetbagging into a State with more generous homestead laws and then pouring their assets into an exempt home.

This, I believe, is an important States' rights issue. Since 1792, Federal bankruptcy laws have deferred to States to decide what property is exempted from bankruptcy. We should not interfere with the decisions that States have made to protect the equity that a person has in their own home. If the proposed homestead cap is put into law, this could force a person who owns a $110,000 home, with no mortgage, and who files for bankruptcy to lose their home. This is because creditors wanting the $10,000 over the $100,000 exemption can force the individual to sell his home.

Senior citizens frequently have most of their net worth in their homes, not in liquid assets. They could be forced to sell their homes, even if a creditor is seeking just a small amount over the homestead exemption.

As legislators, I believe we should not only seek to write laws that provide needed solutions to a problem, but we should also ensure that these laws do not have unintended consequences.

I am for having people pay all the debts that they owe. As you have alluded, I am a very strong supporter of bankruptcy reform, and that is why I have co-sponsored this bill. However, a homestead cap would do nothing toward providing the fresh start we all in believe in, but rather would force honest debtors into selling their homes.

I am confident that the anti-fraud provisions contained in the House bill will provide the perfection we need without being punitive or infringing on States' rights, such as those we enjoy in Texas and in other States. Thank you, Chairman.

[The prepared statement of Mr. Sessions follows:]

PREPARED STATEMENT OF HON. PETE SESSIONS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, thank you for your leadership on the issue of bankruptcy reform. I appreciate the opportunity to testify about how changes to the homestead exemption provision of this bill will greatly affect citizens in my home state of Texas as well as several other states.

I am a cosponsor of this bill and fully support the House version that you, Mr. Chairman, have introduced. This legislation received the bipartisan support of 300 Members last year, and I believe that this compromise reform of the bankruptcy system will require high-income debtors to pay their debts if they have the ability to do so, while protecting those with low incomes and those who truly need the protection that our bankruptcy system has to offer.

However I am concerned about a proposal that is reportedly being considered by the Senate which would place a $100,000 homestead cap on the amount that a family is allowed to exempt from the bankruptcy laws.

This is not an inconsequential change—this cap on the homestead exemption was seriously debated last year when this bill reached the floor of the House. A bipartisan majority of members voted for an amendment on the floor last year to replace the cap with a provision to prevent the *fraudulent* use of the homestead exemption. That amendment effectively targeted homestead exemption abuses without hurting honest debtors and without overriding state laws by removing the exemption in cases of fraudulent conversion of non-exempt assets into exempt homesteads property within 1 year of filing for bankruptcy with the intent to avoid paying creditors.

If the goal is to restrict fraudulent abuse of our bankruptcy laws, this year's bill goes *even further* toward that goal by having a *two*-year residency requirement before a debtor can claim the homestead exemption available in a particular state.

This will strengthen current law by discouraging debtors from "carpetbagging" into a state with more generous state homestead laws and pouring their assets into an exempt home.

This is an important states-rights issue. Since 1792, federal bankruptcy laws have deferred to the states to decide what property is exempted from bankruptcy. We should not interfere with the decisions that states have made to protect the equity a person has in their home.

If the proposed homestead cap is put into place, the law could force a person who owns a $110,000 home with no mortgage and who files for bankruptcy, to lose his home. This is because creditors wanting the $10,000 over the $100,000 exemption, can force the individual to sell his home.

Senior citizens frequently have most of their net worth in their homes, not in liquid assets. They could be forced to sell their homes even if a creditor is seeking just a small amount over the homestead exemption. As legislators, we should seek not only to write laws that provide a needed solution to a problem, but we also must ensure that these laws do not have unintended consequences.

I'm all for having people pay the debts they owe. That is why I cosponsored this bill because I believe it targets debt relief only at those who need the help and works with others to pay a portion to their creditors. However, a homestead cap would do nothing toward providing the "fresh start" we all believe in, but rather would force honest debtors into selling their homes.

I'm confident that the anti-fraud provisions contained in the House bill will provide the protection we need without being punitive or infringing on states rights.

Mr. GEKAS. We thank you very much, and we excuse you with our gratitude.

Mr. DELAHUNT. Mr. Chairman? Before my friend departs, may I just have a——

Mr. GEKAS. I didn't hear the gentleman from Massachusetts as he rose—to be recognized for what?

Mr. DELAHUNT. I would just like to inquire of my dear friend and my corridor mate, Mr. Sessions, as to the issue that he addressed.

Mr. GEKAS. If the gentleman wishes to respond to questions, I am willing to——

Mr. SESSIONS. Mr. Chairman, I would be pleased to respond to the gentleman.

Mr. GEKAS. The gentleman from Massachusetts is recognized.

Mr. DELAHUNT. Yes, thank you, Mr. Chairman. Is it my understanding, then, that you would object to any caps whatsoever?

Mr. SESSIONS. That would be what I—support the testimony that I have given. I believe that States have addressed these issues and decided by themselves, on a State by State basis, what is necessary. And I would ask that the Federal Government not do anything in this bankruptcy protection other than those that we have advanced here. And that would be correct.

Mr. DELAHUNT. Right. But, Pete, you are aware of the fact that States like Texas and Florida have no caps whatsoever?

Mr. SESSIONS. That would be correct.

Mr. DELAHUNT. And that there have been a number of instances where individuals, and let us not call them carpetbaggers, but under your proposed 2-year residency requirement, there have been instances in which individuals have had a primary residence worth millions of dollars—millions of dollars. You are aware of that?

Mr. SESSIONS. I am aware of that, and, in addressing that issue, I would like to say that so are the people who have extended credit to these people; and they are aware of the laws of the State of Texas. And we will always be able to find people that do try and hide their assets in their homes like this. The fact of the——

Mr. DELAHUNT. But I am not even suggesting that anyone, you know, intended to defraud here. I am not even suggesting that particular scenario. But you know there are people who hit hard times that who, if this legislation should pass, will be contrasted in the public's mind with some of those individuals.

Mr. SESSIONS. My observation in response would be then since we are talking about millions rather than thousands that if you put a cap at millions of dollars, then that would be the appropriate level. I am not advocating that. I am advocating that we defer to States. I simply believe that——

Mr. DELAHUNT. And I understand your concern about States' rights and——

Mr. SESSIONS. Well, sir, but what I am suggesting to you is if you are talking about millions of dollars, then put the cap at millions of dollars, not $100,000. That is very punitive for people who live all across this country, who are middle-class people, who are many times people who retired, as my grandfather did in 1971. And I don' think it is fair that we place these types of very onerous dollar amounts on people. So if you want to talk about millions of dollars, then address it as millions of dollars. But please do not address it as a million dollar problem and put it as a $100,000 answer.

Mr. DELAHUNT. So then you see some flexibility there in terms of what I think most Americans would consider fair and equitable to everyone involved so that you would not rule out entirely any kind of cap whatsoever, since this is a Federal statute.

Mr. SESSIONS. Congressman, what I have suggested to you is that I wanted to respond to you very openly, and that is——

Mr. DELAHUNT. And you have, and I appreciate it.

Mr. SESSIONS. That is that I believe there should not be a cap at all and that we should defer to States' rights. My point is to say if you are talking about millions of dollars, then it would seem that that would be the way the law was written and then I would take a look at that. I think that millions of dollars are more reasonable than $100,000.

Mr. DELAHUNT. Like maybe $1 million as opposed to——

Mr. SESSIONS. Perhaps that could be closer, but a hundred thousand dollars simply is an unfair and unreasonable assumption on my part.

Mr. DELAHUNT. Well, thank you, and I appreciate your thoughtful testimony.

Mr. SESSIONS. I thank the gentleman.

Mr. GEKAS. The gentleman from New York indicates that he has a question for you. Do you wish to respond?

Mr. SESSIONS. Mr. Chairman, I will stick around for this.

Mr. NADLER. Thank you. I just want to follow up on what Mr. Delahunt was asking. It seems to me one of the things that people are always puzzled by, and I am puzzled by, is the fairness of a bankruptcy system. I remember when Donald Trump went bankrupt, the court said he could live on an expense account of $400,000 a month, I think it was. So he could maintain some sort of standard of living, and that money obviously wasn't available for his creditors. And I don't understand that kind of reasoning.

But I also don't understand the reasoning of a system in which we say we are going to have a bill to crack down on people who

don't pay their bills. And we are going to have a means test. And we are going to refuse chapter 7 relief for a lot of these people, but at the same time someone can legally shelter millions of dollars, as was said, in a homestead.

I frankly think a hundred thousand dollars is too little, too. But I think a quarter of a million dollars should be more than ample for any State, and I don't see why this as opposed to anything else in bankruptcy is a matter of States' rights except by tradition. And this House invades States' rights all the time. I think many of the people on the other side of the aisle think we should override States' rights on access to their courts, and we should have tort reform that says who can sue whom and under what circumstances and what kind of legal fees they can pay in State courts. So it is sort of strange to hear States' rights only here.

So how would you justify in a bill in which we are cracking down on people, because we are saying that people are abusing the bankruptcy system, allowing people to exempt, let us say more than a half a million dollars in homestead?

Mr. SESSIONS. I thank the gentleman for his question. First of all, I was not trying to set an arbitrary figure. I believe it should be no cap. But I believe that if you look at, since 1792, that the Federal Government, the Congress of the United States, has allowed these States, individually, to determine how they would like to approach homestead exemptions in their own States in dealing with bankruptcy. I believe it is very important. I happen to live in a neighborhood where probably the average house is $250,000. That is perhaps a lot of money. But we are—what we are dealing with here is the essence of individuals and their home, and the old saying that a person's home is their castle I believe is a true statement; that that which you have should be protected. You should not be thrown out of your own home for something that you have done. And creditors recognize this. They know that when they extend credit to you. And I think that there is simply a balance. I am simply saying to you, I believe that a hundred thousand dollars is incorrect, and I believe that it is not unreasonable to assume that we would not put a cap on. I thank the gentleman.

Mr. GEKAS. The time of the gentleman has expired. We thank you very much.

Mr. SESSIONS. Thank you, Chairman.

Mr. GEKAS. And you are excused with our gratitude. And I think that the gratitude of the gentleman who is looking down at us from that portrait up there is also visited upon you. In fact, he is looking askance at us up here as we continue. He agrees with you, I am sure, on your position. We thank the gentleman.

Mr. SESSIONS. Thank you, Chairman.

Mr. GEKAS. It is now time to return to the full-blown hearing to which we are committed. We note the presence now of the gentleman from Ohio, Mr. Chabot, and the gentleman from New York, Mr. Weiner. As has been said in many different ways thus far, this is a historic moment in that the joint hearing scheduled between the Senate and the House and those who are engaged in bankruptcy reform signifies—signals a blending of wills and a blending of concepts as we pursue bankruptcy reform in the current session of the Congress.

From the very first, back in the last session and now replicated here, this has been a bipartisan effort judging from the votes, both the House and the Senate, and on the conference report in the House last year. Further evidence that it is a bipartisan approach is the fact that at the outset in this session, we have fought consistently to bring about a bipartisan study of the measures that and the standards that are going to be applied. We have had several briefings for staff for the minority and the majority. We have had visiting lecturers on the very vexing problem of child support and its role in the primacy that we accord certain entities in the bankruptcy reform measures. We have had a breakfast and a luncheon for all those purposes. These staff briefings will continue, and the next one will be held Tuesday I am informed, is that correct? All of these in the spirit of and in the necessity of bringing about bipartisan understanding and support of bankruptcy reform.

The briefings that will begin Tuesday, by the way, will include not just the bill that we have introduced that is before us now, but that which is potentially to be introduced, as I understand, by Mr. Nadler, if there be one. And if there be one, it will also be part of the presentation that will be made to staff and to members in preparation for these hearings.

We have two concepts that have not changed and will not change and which form the foundation of bankruptcy reform: to guarantee the fresh start to those who are so burdened by debt that they cannot and their families cannot survive without giving them that fresh start; and two, an earnest effort on the part of our society to make certain that those who are able to repay all or part of their debt should be given a mechanism and compelled to enter the halls of bankruptcy with a view for repayment of some of that debt over a period of time.

Those two precepts are unarguable in their meaning. And the debate will fasten on that I am sure as we proceed. But let no one criticize anyone for looking at ways and means to grant a fresh start where it is needed; nor should one be criticized for looking at methodologies for providing repayment of some of the debt by those who are able to pay it.

With that, I will entertain opening remarks by the gentleman from New York, Mr. Nadler.

Mr. NADLER. Thank you, Mr. Chairman. Mr. Chairman, today we begin our hearings on bankruptcy legislation. As you know, our Senate colleagues will be unable to participate in today's hearing, or most of it, because of floor votes. Senators who had intended to present testimony to us today will be unable to do so. I would hope that we could accommodate them when we hear from members next week. I think our colleagues from the other body have something to contribute. I hope we can accommodate them.

Mr. Chairman, as you well know, I have not reintroduced the legislation that Mr. Conyers and I introduced last year, because I thought it necessary to take a fresh look at some of the issues before us and approach this matter with an open mind. To that end, we have been in contact with professionals from across the spectrum, from business lawyers to creditor representatives, to administrators in an effort to gain a better understanding of what they

think we ought to do to ensure fairness, balance, honesty, and efficiency in our bankruptcy system.

I know we have had some rather strong differences over some parts of this legislation; that is, the legislation that you introduced last year and that you have reintroduced. As you know, I think it is one of the most unbalanced and one-sided piece of legislation I have ever seen. But I would hope that we could use these hearings as an opportunity to learn and perhaps find creative approaches to some of these difficult questions.

Next week, I know that you have scheduled nine panels in 3 days and that our staffs have been discussing possible witnesses to provide members with a broad spectrum of views. I am concerned that these hearings, packed so tightly—three panels a day in 3 days, with a possible markup the following week—in such a short period of time may leave little time for deliberation. Some may conclude that they are window dressing for a pre-determined outcome. I will not say that. I hope that, in fact, there will be some time after those hearings before the markup; that you will not schedule a markup for the week after so that people will have time—since they won't have time to think between those hearings 1 day to the next, to think about what we have heard and to talk to each other so that we could actually reflect what we have heard in those hearings in the legislation.

Obviously, were markups scheduled for the following week, I would certainly conclude that there was a pre-determined outcome and that the hearings were window dressing. I hope that will not happen. I hope that we can actually review the testimony and have the time to do that, and shape legislation together that reflects the best advice we have received.

We may not agree on all points, but we may be able to narrow the range of issues and at the very least to clarify our points of disagreement.

I certainly hope that these hearings will not be merely an exercise in creating the appearance of fact finding prior to a pre-determined course of action. I hope that we do not simply rush last year's product through the process without any heed to the many thoughtful comments we have received and will receive from across the professional spectrum, especially during these hearings.

I know I was, as were many professionals, deeply disappointed to see the reintroduction of last year's conference report, down to all the typos, which were not corrected, and without even correcting the technical errors that I know had been brought to the attention of the majority staff. I hope it does not portend the future course of this legislation.

Mr. Chairman, despite my uneasy feeling that American families may be about to get the bum's rush from Congress, I begin these hearings hopefully, with an open mind and a strong desire to work with you to improve our nation's bankruptcy system. I know that any such attempt will result in a bill that has yet to be written. Thank you, Mr. Chairman.

[The prepared statement of Mr. Nadler follows:]

PREPARED STATEMENT OF HON. JERROLD NADLER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Thank you, Mr. Chairman. Well, it's deja vu all over again. Or as someone once observed, if history repeats itself, the first time is tragedy, the second time is farce. Unfortunately, for millions of Americans whose families, businesses, jobs, communities and futures will be touched by the Bankruptcy Code today's travesty may be farcical, but it is far from funny.

Let us review: The Chairman has reintroduced his conference bill from last year, without so much as correcting the typos or the technical errors, much less attempting to deal with the many serious policy problems pointed out by professionals from across the spectrum—judges, trustees, debtor attorneys, unsecured trade creditors, creditor attorneys, academics. Anyone who does not have a special interest provision in this bill, or who is not on their payroll, has criticized this bill, but the Chairman has ignored the unified voice of the profession.

We did have a hurried hearing schedule over four days. I will give the Chairman credit for inviting some very good witnesses whose testimony was thoughtful and informative. Unfortunately, the hearings appear to have been merely for show and do not appear to have had any impact on the proponents of this legislation. They were, quite simply, hearings without listening—the legislative equivalent of one hand clapping.

We have before us a substitute which the minority received late last night. I hope the Chairman will not be offended to discover that we have not had the opportunity to comb carefully through all 310 pages. Perhaps, after the markup, we will have the chance to find out what it was we were being asked to vote on.

We really have reached a crossroads today. I wish to share with the Chairman and the members of the Subcommittee a letter I received from Jack Lew, the Director of OMB, reiterating the President's strong objections to the Conference Report from last year, which is embodied in this bill, and reiterating the President's determination to veto this bill and work for real fair and balanced reform. Let me quote:

> "We were disappointed that the Conference Report failed to include key provisions of the Senate bill, thus failing the test of balance. In my letter to Congressional leadership dated October 9, 1998, I noted that the President's senior advisors recommended that the President veto the Conference Report. Our position from last year has not changed."

Now, Mr. Chairman, you know that I did not introduce my bill from last year, but have decided to take a fresh start and work with professionals from across the spectrum, with a broad variety of interests affected by the Code—indeed, just yesterday I met with representatives of Visa to open a dialogue—in an effort to find a common ground. I urge you and my colleagues on both sides of the aisle to join me in that endeavor so that we can achieve real, balanced and workable bankruptcy reform by the end of this Congress. Another futile war of words will accomplish nothing.

I will not offer many amendments today, but I hope that after this markup, we will have the opportunity to work together, to start anew, to work with the experts, with the President and with our colleagues to get it right this time.

Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. GEKAS. We thank the gentleman. Time has expired. Does anyone from the—the gentleman from Ohio indicates that he would have an opening statement. The gentleman from Tennessee if recognized for 5 minutes.

Mr. BRYANT. Mr. Chairman, I just simply want to say that based on the positioning here, I am honored to be senior to Senator Thurman, who is not here. Perhaps that is a classic example of the bankruptcy fresh start. [Laughter.]

Mr. GEKAS. The gentleman from New York, does he wish to make an opening statement?

Mr. WEINER. I have no opening statement.

Mr. GEKAS. The gentleman from Massachusetts is recognized for 5 minutes.

Mr. DELAHUNT. Yes, thank you, Mr. Chairman. I am not going to take all 5 minutes. But I want to express similar concerns that were expressed by the ranking member, Mr. Nadler.

We had two members, two brand new members, speaking to the concept of fresh start on this side of the aisle, Ms. Baldwin and Mr. Weiner. This is very complicated material. Last year, you and I had this discussion about the scheduling of hearings. And I think it is a grave mistake to schedule three consecutive days on this subject, with three different panels. You and I know that there will be—it will be impossible for members to attend to each and every one of these panels. I think that is a mistake.

I also want to note that last year, myself and Mr. Nadler filed a request in January 1998 with the Congressional Budget Office for information, an analysis on the issues surrounding personal bankruptcy. And I want to enter into the record a letter dated March 10, 1999. It is addressed to Congressman Nadler. Dear Congressman, I am writing in regard to your request of January 14, 1998, for background information on issues surrounding personal bankruptcy. The staff analysis is almost complete. And I will review it carefully or soon get it done. Although we have many other assignments from Congress, I am sure that the material will be ready for release to you by the end of March.

I think it is appropriate, since we made this request, since there is serious disagreement in terms of various analysis by both the credit industry and others that we wait clearly in terms of markup until the CBO has provided us with an independent analysis of the information I think that is absolutely essential before we can make a reasoned, thoughtful decision in terms of where we go.

And I would also recommend, and I think it would be very, very fruitful, Mr. Chairman, that we consult in an informal basis to see among members—among those of us that serve on this committee to see where there are areas of agreement. We didn't do it last year, and we failed to have a bill. I think if we sit down with each other and work—in fact, my friend and colleague from New York just asked me. He said, gee, it looks to me as I become conversant with the issues that we are going to be addressing here is that there is a lot that we can agree on. I think if there is a sincere and genuine intent to do something that would come out of the committee where we could all support—and maybe there would be some dissatisfaction—that it would be appropriate for us to sit down and consult in good faith in a reasonable period of time to determine whether is areas that we can agree on.

And I yield back.

Mr. DELAHUNT. Would the gentleman yield for a moment? I yield to the chairman.

Mr. GEKAS. I'll yield myself what time I may consume. I simply refer back to my opening statement in which I took special aim at the fact that we have provided the staff briefings, the breakfasts, the luncheons, more staff briefings. We have been accommodating in any request that any member of the minority has been making. This bill is a replication, by and large, of the issues of last year. Those that were in the last session have a head start like all of us. Those who, like Mr. Weiner, need to catch up are given fresh opportunities every day to do so, with these briefings. I will not refuse to meet with anyone on any subject at any time. And informal discussions following staff briefings may be appropriate. But I will not abide by any comment that we are bludgeoning our way

through this process. This is well-calculated to inform every member, to allow full study by every member, to allow full participation by every member, to allow full presentation of individual views, to ask for special meetings between interested parties, to bring outside consultants in at any time as we have strenuously attempted to do, and we will continue to do so. So the issue is joined. We will be accommodating, and we will continue to be accommodating.

Mr. NADLER. Will the chairman yield?

Mr. GEKAS. Not at this time. We want to proceed with the hearing. Well, all right, Mr. Nadler, you may proceed?

Mr. NADLER. Thank you. I appreciate hearing these sentiments. I want to pick up on one thing the gentleman from Massachusetts said and ask the chairman if he would join me in something. The CBO has sent me a letter dated a few days ago in response to our request of 14 months ago that their study will be completed by the end of March after these hearings will be completed. We have asked if they could make available to the committee as a witness for next week's hearings, the expert on their staff who has been doing all the work. And they have said that they didn't think so.

Frankly, my suspicion is someone doesn't want that information before the committee. I don't know who that is, not necessarily anyone on the committee. So I would ask the chairman if he would join me in requesting the CBO to allow its own person who is writing that report, who is largely, according to them, has completed it, to appear as a witness before our committee next week?

Mr. GEKAS. I have no objection to your calling any witness that you want. And I will join with you——

Mr. NADLER. Thank you.

Mr. GEKAS [continuing]. On the CBO and also the Surgeon General if you like.

Mr. NADLER. Well, I think that's a little far afield, but I appreciate the chairman's response.

Mr. DELAHUNT. I would appreciate the Surgeon General, Mr. Chairman.

Mr. GEKAS. Me, too. Because my blood pressure is going up.

Mr. DELAHUNT. Maybe he could cut out some of the fat.

Mr. GEKAS. In any event, we shall proceed with the opening statement of the gentleman from Ohio, Mr. Chabot?

Mr. CHABOT. Thank you, Mr. Chairman. My distinguished colleague from New York, he mentioned I think he said this was the most unbalanced and one-sided legislation that he had ever seen. I would take issue with that. I don't think that's accurate. I think it's good legislation. And I think it's interesting to note that there are 23 Democratic cosponsors to this legislation. I think if it was that one-sided, we wouldn't see that much support from Democrats on this bill.

I would agree with Chairman Gekas that it's vital that we work together in a bipartisan and bicameral manner to move this legislation forward as expeditiously as possible.

This reform legislation will protect consumers and businesses from irresponsible debtors who are capable of paying their debts, but choose to hide behind bankruptcy protection instead. In particular, this legislation would re-establish the link between a debtor's ability to pay and the availability of a legal remedy to dis-

charge debt through bankruptcy. Under the need-based reforms, those that have the ability to pay back either $5,000 or 25 percent of their debts will be required to file under chapter 13 and work out a repayment plan.

There are, of course, some people who truly have a legitimate need for bankruptcy. At times, hard-working families may face a serious family illness, a disability, unemployment or the loss of a spouse which may necessitate the need for bankruptcy protection. Too frequently, however, people who have the financial ability or earnings potential to repay their debts are seeking an easy way out as a growing number of financially secure individuals attempt to use chapter 7 bankruptcy as a way simply to walk away from their debts. While this may prove convenient for the debtor, it's not fair to their friends and their neighbors who ultimately are stuck with the bill.

Consumer bankruptcies have a dramatic impact on businesses and consumers, reducing the availability of credit, and increasing the price of goods and services in this Nation. For example, it is estimated that the consumer bankruptcies in 1997 alone wiped out about $40 billion in consumer loans costing every American household, we used to say $400, we now come to find out it's $550 per family. That's essentially a hidden bad debt tax on every single American family. That's money that American families could use for a vacation, to go toward education, or their children's clothing or a movie or whatever. But that's money that we take away from American families right now and I think that's wrong.

Nationally, consumer bankruptcies reached a record $1.4 million back in 1997 and it's projected that they'll go even higher this year. What makes these numbers particularly alarming is the fact that this trend began back in 1994 during a time of solid economic growth, low inflation, and low unemployment. The primary culprit for this dramatic increase is a system I believe that allows consumers to evade personal responsibility for their debts too easily. Our current bankruptcy system allows many who can't afford to pay a significant portion of their bills to walk away essentially scot-free.

Mr. Chairman, I believe that your bill, H.R. 833, makes significant steps in closing this loophole. I also believe that the means-testing equation included in this bill will prove to be a fair one. Despite criticism, the means-test proposed actually protects low-income debtors, maintains flexibility to take an individual filer's needs into account, and respects judicial discretion in these matters.

I believe we should work closely with our colleagues to pass this legislation quickly so that we can finally give hard-working Americans protection from those who abuse the bankruptcy system and leave their fellow Americans holding the bill.

I yield back the balance of my time.

[The prepared statement of Mr. Chabot follows:]

PREPARED STATEMENT OF HON. STEVE CHABOT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Let me just take this time to welcome the esteemed members of the Senate who have joined us today to discuss this important legislation.

I agree with the Subcommittee Chairman, Mr. Gekas, that it is vital that work together in a bipartisan and bicameral manner to move this legislation forward expeditiously.

This reform legislation will protect consumers and businesses from irresponsible debtors who are capable of paying their debts, but choose to hide behind bankruptcy protection instead. In particular, this legislation would reestablish the link between a debtor's ability to pay and the availability of a legal remedy to discharge debt through bankruptcy. Under the "needs-based" reforms, those who have the ability to pay back either $5,000 or 25% of their debts will be required to file under Chapter 13 and work out a repayment plan.

There are, of course, some people who truly have a legitimate need to declare bankruptcy. At times, hardworking families may face a serious family illness, disability, unemployment, or the loss of a spouse, which may necessitate the need to seek protection. Too frequently, however, people who have the financial ability or earnings potential to repay their debts are seeking an easy way out, as a growing number of financially secure individuals are attempting to use Chapter 7 bankruptcy as a way to simply walk away from their debts. While this may prove convenient for the debtor, it is not fair to their friends and neighbors who ultimately stuck with bill.

Consumer bankruptcies have a dramatic impact on businesses and consumers—reducing the availability of credit and increasing the price of goods and services. For example, it is estimated that consumer bankruptcies in 1997 wiped out over $40 billion in consumer loans, costing every American household $400. *That's a hidden "bad debt" tax on every single American family.*

Nationally, consumer bankruptcies reached a record 1.4 million in 1997 and are projected to be even higher in 1999. What makes these numbers particularly alarming is the fact that this trend began in 1994, during a time of solid economic growth, low inflation and low unemployment.

The primary culprit for this dramatic increase is a system that allows consumers to evade personal responsibility for their debts too easily. Our current bankruptcy system allows many who can afford to pay a significant portion of their bills to walk away debt free.

Mr. Chairman, I believe that your bill, H.R. 833, makes significant steps in closing this loophole. I also believe that the "means testing" equation included in this bill will prove to be a fair one. Despite criticism, the "means test", proposed actually protects low income debtors, maintains flexibility to take an individual filer's needs into account, and respects judicial discretion in these matters.

I believe we should work closely with our colleagues in the Senate to pass this legislation quickly so that we can finally give hard-working Americans protection from those who abuse the bankruptcy system, and leave them holding the bill.

Mr. GEKAS. We thank the gentleman for the opening statement. We acknowledge the presence now of a fighter in the world of bankruptcy reform, the Congressman from Virginia, Mr. Moran, who wants to make a brief opening statement I think.

Mr. MORAN. Thank you, Mr. Chairman. We're marking a supplemental appropriations bill, but I felt it was important to have at least some Democratic presence in favor of this bill because I believe it is a balanced bipartisan bill. We have a system that is out of control now. We ought not have 1.4 million bankruptcies. We should not have such an escalating trend under chapter 7 where you wipe out your debts instead of working them out.

And the fact is that people like the chairman and Congressman Boucher, a Democrat, another Democrat from Virginia, and Mr. McCollum have been working on this for many years. But each year that we don't pass it, the situation gets worse. I know you've heard the statistics but it just is not fair for every household to be paying about $400 a year to meet the bad debts incurred by other people who, in fact, are using the system. And we estimate that for everybody that uses bankruptcy as a financial management tool, if you will, as a convenience to wipe out their debts, it costs about 15 other families to be able to make up that cost. Families who would never think of reneging on their debts.

So that's not the kind of system that we can be proud of nor can we accept as being sanctioned by Federal law. Fifteen responsible borrowers are more important than the person who is using the system which is occurring today.

We've got lots of provisions here. It is need-based. If you're a family of four with income of $51,000, you can choose what you want to do, clearly. And most, if they are having financial problems, they'll choose chapter 7. We're going after people who can clearly afford to pay off their debts. We've added more provisions that makes it an even more palatable bill for those who want to look out for the rights of consumers.

This bill did pass overwhelmingly. It should pass with an even greater margin this year because a number of the provisions, for example, a lot more information available for debtors where we provide financial counseling for them, all kinds of different options for working out their debts. We've got a Debtor's Bill of Rights. And this is something that I think is important. People who think the principal problem is credit cards and, in fact, the statistics show that it really isn't because only 3.7 percent of consumer debt is accounted for by credit cards. But nevertheless, we require credit card companies to make it clear that if you only pay the minimum balance, then you could be paying for the rest of your life. They have to make it clear how long the debt will be sustained if you only pay the minimum balance. That's the kind of consumer information that is terribly important that I think is a very progressive addition to this bill. We also are going to make it very difficult for these bankruptcy mills to operate that prey upon people who are in desperate situations.

We got 300 votes on the House floor last October 9th. This is an even better bill from the standpoint of people are concerned about consumer's rights, rightfully so. So we've added even more. And it retains the discretion of bankruptcy judges. It protects low-income debtors. It takes into account the unique circumstances of individual debtors. It really only goes after people who are using the system. We ought to be going after them because it's not fair for 15 families who are paying off their debts to also have to pay off the debt of people who are not paying their debts, who are gaming the system today.

So it's a good bill and it's bipartisan and it's balanced and it ought to pass this committee.

Thank you, Mr. Chairman.

Mr. GEKAS. We thank the gentleman for his commentary and to thank him for being one of the chief cosponsors, which provides the Chair with a segue into asking unanimous consent to permit the statements of Bill McCollum and Congressman Boucher, also original cosponsors of the legislation, to be entered into the record?

[The information referred to follows:]

PREPARED STATEMENT OF HON. BILL MCCOLLUM, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

I commend Chairman Gekas and Chairman Grassley for holding this joint hearing on the need for bankruptcy reform. Members from both sides of the aisle and both Houses of Congress have dedicated enormous time and energy to reforming the existing bankruptcy system. The Bankruptcy Reform Act of 1999, which has been introduced in the House, is the product of that effort.

The Bankruptcy Reform Act of 1999 clearly strikes a balance between House and Senate reform proposals. The legislation retains the needs-based test supported by the House but uses the Senate procedure to determine if someone should be in Chapter 13 rather than Chapter 7. The bill includes the most protective provisions in both House and Senate bills to safeguard support payments to women and children. There are expanded protections for retirement savings and education savings accounts. There are also new protections concerning reaffirmations and penalties against creditors who act improperly. In addition, the legislation includes new consumer protections regarding credit lending.

The Bankruptcy Reform Act of 1999 is a well-balanced compromise which protects support payments to women and children, provides additional consumer protections, and restores increased personal responsibility to the bankruptcy system. Our nation's bankruptcy laws play an important and necessary role in our society but we must ensure that our bankruptcy system does not unintentionally encourage those who can take responsibility for their financial obligations not to do so. Such an abuse of our bankruptcy laws is fundamentally unfair to those who play by the rules and take responsibility for their personal obligations.

Congress has a special responsibility to address this issue and to ensure that our bankruptcy laws operate fairly, efficiently and free of abuse. I am confident that this hearing will highlight the need for Congress to pass bankruptcy reform legislation and look forward to working with my colleagues towards that end.

PREPARED STATEMENT OF HON. RICK BOUCHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Chairman Grassley and Chairman Gekas, thank you for the opportunity to appear before you and the Members of the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee and the Subcommittee on Administrative Oversight and the Courts of the Senate Judiciary Committee.

I was pleased to join in a bipartisan effort with Chairman Gekas and my friends and colleagues Rep. Bill McCollum and Rep. Jim Moran in introducing the Bankruptcy Reform Act of 1999. This legislation is intended to ensure that our bankruptcy laws operate fairly, efficiently and free of abuse. Our legislation is virtually identical to last year's conference report which garnered the support of 300 of our House colleagues. That report was the product of nearly two years of hearings, mark-ups, deliberation and compromise.

In an era where real per-capita annual disposable income is growing, unemployment rates are low and the economy is strong, bankruptcies should be rare. However, bankruptcy filings are increasing dramatically. In fact, in 1998, filings reached a record high of 1.4 million, with an estimated $50 billion in consumer debt discharged.

Bankruptcies of convenience are driving this enormous increase. Bankruptcy was never meant to be used as a financial planning tool, but it is becoming a first stop rather than a last resort because our current bankruptcy system encourages people to walk away from their debts regardless of whether they have the ability to repay any portion of what they owe.

Responsible borrowers and the consumers of all goods and services pay the price for bankruptcies of mere convenience. The typical American family pays a hidden tax of $500 each year because of increased charges for credit and higher prices for goods and services attributed to bankruptcies of mere convenience.

Today's consumer bankruptcy system is fundamentally flawed. The current Bankruptcy Code makes virtually no attempt to calibrate the level of bankruptcy protection to the level of each debtor's need. Rather, it allows a debtor to discharge debts even if the debtor can repay a large portion of them. Currently, approximately 70 percent of bankruptcy filers use Chapter 7, which has no provision for debt repayment even if the filer can repay. Only 30 percent use Chapter 13, which sets up repayment plans. At present, individuals with significant income and the ability to repay some of their debts can obtain the same full discharge of debts as individuals with little or no income and assets.

Our legislation addresses this problem by requiring that a debtor demonstrate that he or she actually needs bankruptcy relief and, if so, provides only the amount of relief that is needed. This needs-based system would create a simple formula, based on a debtor's income and obligations, to determine exactly how much relief the debtor needs. Individuals with no means to repay their debts could file for bankruptcy under Chapter 7, thereby obtaining complete debt relief and a fresh start. Individuals who can repay a portion of their debts would file under Chapter 13 and begin a repayment plan based on what they can afford.

With this change in the Bankruptcy Code, the bankruptcy system would protect consumers in financial difficulty without unfairly imposing inappropriate additional costs and burdens on consumers who continue to pay their debts.

All consumers should benefit from this legislation—every consumer pays higher prices for goods and services and higher interest rates as a result of bankruptcy losses. Enactment of the "Bankruptcy Reform Act of 1999" will reduce the level of those bankruptcy losses, thereby reducing the cost of credit and goods and services for all consumers.

I am pleased to be a sponsor of this legislation and look forward to working with each of you to ensure its passage.

Mr. MORAN. Thank you, Mr. Chairman.

Mr. GEKAS. Thank you. Now we are poised to hear the first panel. And we invite to the witness table Dean Sheaffer. Mr. Sheaffer is vice president and director of credit at Boscov's Department Stores, Inc., a regional department store chain, located primarily in New York, New Jersey, Maryland, Delaware, and Pennsylvania. In addition to his responsibilities with Boscov's, Mr. Sheaffer is vice chair of the Pennsylvania Retailer's Association and vice president of Pennsylvania's first statewide economic development corporation, Grow Pennsylvania Capital.

He is testifying here today on behalf of the National Retail Federation, which is the world's largest retail trade association with a membership representing every facet of the retail industry. The Federation represents an industry that encompasses 1.4 million American retail establishments, which in turn employ more than 20 million individuals across our Nation.

He is joined at the table by Bruce Hammonds, who has 29 years of experience in consumer lending. His current responsibilities include overseeing MBNA credit loss prevention and consumer finance and technology services. A graduate of the University of Baltimore, Mr. Hammonds is a director of the Delaware State Chamber of Commerce, the Delaware Housing Partnership, and the Delaware Business Roundtable. He also serves on the board of trustees of Goldey Beacom College and is a member of the College of Business and Economics Visiting Committee at the University of Delaware.

MBNA America Bank, N.A. is the largest independent credit card lender in the world and one of the two largest credit card lenders overall. It has more than 20,000 employees in 28 offices located in the United States, Canada, and the United Kingdom. MBNA and its subsidiaries have $60 billion in managed loans outstanding.

With them at the table is the Honorable Carol J. Kenner, United States bankruptcy judge, District of Massachusetts. Judge Kenner was appointed a bankruptcy judge for the District of Massachusetts in 1986 and served as chief judge from 1994 through 1996. She also has served on the Bankruptcy Appellate Panel for the First Circuit since 1996. Prior to her appointment to the bench, Judge Kenner practiced exclusively in the areas of corporate reorganization and bankruptcy law in private firms in Boston and New York City. Judge Kenner obtained her Juris doctor degree magna cum laude from the New England School of Law in 1977.

To the left of the judge is Larry Nuss, the manager and CEO of the Cedar Falls Community Credit Union since 1979. Cedar Falls Community Credit Union is an employee-based credit union, which currently serves 83,000 members. Prior to his assuming his respon-

sibilities with Cedar Falls, Mr. Nuss was employed as a collection manager for Rath Employees Credit Union from 1976 to 1979. Since 1981, Mr. Nuss has served as the director for the Iowa Credit Union League. And in addition, currently is vice chairman of that League.

Mr. Nuss is appearing today on behalf of the Credit Union National Association, an organization that represents more than 11,000 State and Federal credit unions nationwide.

The final member of this panel is Gary Klein, who is well-known to this committee. He is a senior attorney at the National Consumer Law Center, where he specializes in consumer bankruptcy, consumer credit, and foreclosure law. He is also director of the Center's Sustainable Home Ownership Initiative, which represents low-income homeowners. Mr. Klein has authored several books on bankruptcy, on foreclosure, and on the Truth in Lending Act.

The National Consumer Law Center is a nonprofit organization that specializes in consumer credit issues on behalf of low-income people.

As is our custom, we will produce for the record any written statement that you may have offered, as you've already submitted. Without objection, they'll be included in part of the record. We'll ask each one of you to speak for about 5 minutes in summarization of your full statement.

We'll begin with Mr. Sheaffer.

STATEMENT OF DEAN SHEAFFER, VICE PRESIDENT AND DIRECTOR OF CREDIT, BOSCOV'S DEPARTMENT STORE, INC., LAUREL DALE, PA, REPRESENTING THE NATIONAL RETAIL FEDERATION

Mr. SHEAFFER. Good afternoon. My name is Dean Sheaffer. I'm vice president and director of credit for Boscov's Department Stores. Boscov's is a family-owned regional department store chain operating in the Mid-Atlantic States. Our largest number of stores is in Mr. Gekas' home State, Pennsylvania.

I'm testifying on behalf of the National Retail Federation. Boscov's is a member of the NRF, and I'm an active member of its Credit Management Advisory Council.

I would like to thank the chairman for providing me with the opportunity to testify before these distinguished committees. I would also like to take just a moment to thank the chairman, Mr. Gekas, for all of your hard work last year on H.R. 3150. Your unique understanding of the retail position and the retail issues is truly appreciated.

The National Retail Federation is the world's largest retail trade association. The NRF members represent 1.4 million U. S. retail establishments, employs 20 million Americans, about one in five American workers, and registered 1998 sales of $2.7 trillion.

NRF's members and their customers are greatly affected by the recent surge in consumer bankruptcies. In the past 3 years, national filings have risen more than 60 percent. In Pennsylvania, our home State, chapter 7 bankruptcies have grown by 90 percent in that same time period. Last year, there were nearly 1.5 million bankruptcy filings. The overwhelming majority of which were consumer bankruptcy filings.

Today, we have a strong economy. We set another record in the stock market yesterday. We had the lowest unemployment in a quarter of a century. And, yet, at the current rate of bankruptcy filings, within the next decade one in seven American families will have filed bankruptcy.

At Boscov's in 1994, we wrote off $1.2 million in bankruptcy losses, about 35 percent of our total credit losses. In 1997, that number had nearly quadrupled to $4.6 million, and 50 percent of our total credit losses. It is estimated that over $40 billion nationwide was written off in bankruptcy losses last year. That amounts to a discharge of $110 million every single day.

When an individual declares bankruptcy rather than paying the $300 they may owe Boscov's or the thousands of dollars they may owe in State taxes or other bills, it forces the rest of us to pick up their expenses. Last year to make up for these losses, it costs each of our households hundreds of dollars.

I want to be clear, we cannot eliminate all of these losses. Some of them are unavoidable. Bankruptcy must remain an option for those who have experienced serious financial setbacks and who have no other means for recovering. Most people who file for bankruptcy need the relief. We must be very careful to distinguish the average filer who uses the system properly from the smaller but important group of others who mis-use the system for their benefit. It is with this trend that we must be concerned, with those who use the system to wipe out their debts without ever making a serious effort to repay them.

In my experience at Boscov's, the vast majority of our customers pay as agreed. In the past we would occasionally see a few customers whose payment patterns were more erratic. They might fall behind a few months, make a few payments, catch up, go back and forth. Today, however, we see a very different picture. Often our first indication that a customer is in serious financial difficulty is when we receive their petition of bankruptcy.

Recently, we did a study and found that almost half of our petitions for bankruptcy came from customers who were not seriously delinquent on our account when they made the decision to declare bankruptcy.

Last year, we strongly supported the bill introduced by Mr. Gekas and Mr. Moran. It provided a simple, up-front, needs-based formula that allowed the overwhelming majority of those who needed bankruptcy relief in chapter 7 to have it with virtually no questions asked. But for that sub-group of filers, for those higher income individuals who would use chapter 7 to push their debts on to others regardless of the filer's ability to pay, the up-front, needs-based approach would have said, "No, pay what you can afford." The Senate took a different approach in S. 1301. They relied far more heavily on tweaks to the current system to address the problem.

For retailers such as Boscov's, a typical balance on our card in bankruptcy may be $500 or $600. With a recovery in a chapter 13 bankruptcy being maybe 30 cents on the dollar, it would not make economic sense for Boscov's to spend hundreds of more dollars, it not thousands, to try to move a customer from chapter 7 to chapter 13 to receive maybe $3 a month or $150 in total recoveries.

In closing, on behalf of the National Retail Federation, we urge Members of Congress to take swift legislative action to address the problems confronting the Nation's bankruptcy system. If we are not careful, the costs of the rising tide of discretionary filings may tax society's compassion for those in genuine need. We must not allow that to happen. I believe that it is imperative for Congress to pass common sense bankruptcy reform legislation this year consistent with H.R. 3150.

Thank you very much.

[The prepared statement of Mr. Sheaffer follows:]

PREPARED STATEMENT OF DEAN SHEAFFER, VICE PRESIDENT AND DIRECTOR OF CREDIT, BOSCOV'S DEPARTMENT STORE, INC., LAUREL DALE, PA, REPRESENTING THE NATIONAL RETAIL FEDERATION

Good Morning. My name is Dean Sheaffer. I am Vice President for Boscov's Department Stores. Boscov's is a regional department store chain primarily located New York, New Jersey, Maryland, Delaware, and Pennsylvania. I am testifying on behalf of the National Retail Federation. Boscov's is a member of NRF, and I am an active member of its Credit Management Advisory Council. I would like to thank the Chairmen for providing me with the opportunity to testify before these distinguished committees.

The National Retail Federation (NRF) is the world's largest retail trade association with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalogue, Internet and independent stores. NRF members represent an industry that encompasses more than 1.4 million U.S. retail establishments, employs more than 20 million people—about 1 in 5 American workers—and registered 1998 sales of $2.7 trillion. NRF's members and the consumers to whom they sell are greatly affected by the recent surge in consumer bankruptcies.

Bankruptcies are out of control. In the past 3 years, national filings have risen more than sixty percent (60%). In Pennsylvania where we are based, Chapter 7 bankruptcies have grown by 90 percent in that same time period. Nationally, we continue to exceed the one million filing record set in 1996. Last year there were nearly 1.5 million bankruptcy filings, the overwhelming majority of which (more than 95 percent) were consumer filings.

Mr. Chairman, I would like to put these numbers in perspective. Bankruptcy filings are nearly four times higher now than they were during the much worse economic conditions that existed in 1980. Now, we have a strong economy, a record setting stock market, the lowest unemployment in a quarter of a century; the public is optimistic about the future. And yet, if the current rate of filings holds (and it's not going down) within the next decade, 1 in every 7 American households will have filed for bankruptcy. The system is out of whack.

It is estimated that over $40 billion was written off in bankruptcy losses last year, which amounts to the discharge of at least $110 million every day. This money does not simply disappear. The cost of these losses and unpaid debts are borne by everyone else. When an individual declares bankruptcy rather than pay the $300 they may owe to Boscov's, or the thousand dollars they may owe in state taxes or other bills, they force the rest of us to pick up their expenses. Everyone else's taxes are higher, everyone else's credit is tighter, and everyone else pays more for merchandise as a result of those who choose to walk away. The nation's 100 million households ultimately pay that $40 to 50 billion. Last year, to make up for these losses, it cost each of our households several hundred dollars. This year's number threatens to be even higher.

Now I want to be clear. We cannot eliminate all of these losses. Some of them are unavoidable. Bankruptcy must remain an option for those who have experienced serious financial setbacks and who have no other means of recovering. The bankruptcy system exists to help those who have suffered a catastrophic accident, illness or divorce, or those who have experienced the loss of a business or job from which they cannot otherwise recover. It is both the safety net and the last resort for people in trouble. The knowledge that the bankruptcy system exists to catch them in a financial fall, even though it might never be used, is important. Finally, most people who file for bankruptcy need relief. We must be very careful to distinguish the average filer, who uses the system properly, from that smaller, but important group of others who misuse the system for their benefit.

It is this trend with which we must be concerned. We believe changing consumer attitudes regarding personal responsibility and inherent flaws in our bankruptcy process have caused many individuals, who do not need full bankruptcy relief, to turn to the system regardless. They use it to wipe out their debts, without ever making a serious effort to pay. Some of this change in usage results from a decline in the stigma traditionally associated with filing for bankruptcy. Some of it results from suggestions by others who urge individuals to use bankruptcy to "beat the system." Whatever the cause, it must be stopped.

My experience at Boscov's, and that of credit managers at other stores with whom I have spoken, convinces me of this fact. For example, for many years we tracked the payment history of those of our customers who carry and use the Boscov's card. The vast majority of our customers pay as agreed. In the past, however, we would occasionally see customers whose payment patterns were more erratic. They might fall behind by a few months, make payments to catch up, fall behind again, attempt to recover, and so forth. This kind of payment history suggested to us that the customer was experiencing some sort of financial difficulty. We would monitor the account and intervene as necessary, perhaps by suggesting consumer credit counseling or by limiting their credit line so as to minimize the amount of damage, prior to their possibly experiencing a financial failure.

Today, however, we see a very different picture. Often the first indication we receive that an individual is experiencing financial difficulty is when we receive notice of his bankruptcy petition. Recently at Boscov's, almost half of the bankruptcy petitions we receive are from customers who are not seriously delinquent with their accounts. The first indication of a problem is the notice that they have filed for bankruptcy. It appears that bankruptcy is increasingly becoming a first step rather than a last resort.

Individuals must have a good credit history to qualify for and continue to use a Boscov's card. Yet we, and other retail credit grantors, have been receiving bankruptcy filings without warning from individuals who have been solid customers for years.

We all experience temporary financial reversals in life. Most of us learn that, if you grit your teeth and tighten your belt a notch, you can get through it. But many people no longer see it that way. The rising bankruptcy filings reflect this. Professor Michael Staten at Georgetown University analyzed thousands of Chapter 7 petitions in courts all over the country. His review of debtors' own financial statements gives a strong indication of what is going wrong.

Individuals have a choice as to whether to file in Chapter 7, which generally wipes out all their unsecured debts, or if they file in Chapter 13, often known as a wage-earner plan. Instead of wiping out everything, a Chapter 13 filer attempts to pay as much as he or she can afford and the court discharges the rest. Not surprisingly, most people choose to file in Chapter 7.

But many people who are filing in Chapter 7 do have the ability to pay some or all of what they owe. I understand that various studies have pegged this number as being anywhere from 30,000 filers per year to eight times that number. Whatever the figure, we should not treat bankruptcy as a "get out of debt free" card that can be used by thousands of filers every month, with virtually no questions asked.

Why are so many persons asking the court to make others pay their debts for them? Why aren't they ashamed to go into bankruptcy court? We think that there are a number of factors.

Part of it is lawyer advertising. We have all seen the ads on TV by lawyers promising to make individuals' debts disappear. Some don't even mention bankruptcy—they talk about "restructuring" your finances. I question whether these aggressive advertisers inform their clients about the serious downsides of filing for bankruptcy. There are also bankruptcy petition preparers: clerk typists who simply fill out forms for filers. The client may never meet a lawyer. And with the widespread use of the Internet, websites that proclaim "File bankruptcy for as little as $99" are multiplying. I firmly believe these low cost "bankruptcy mills" are part of the problem.

I also believe that part of the problem is the declining social stigma associated with filing for bankruptcy. At a time when 1 in every 75 households files for bankruptcy, everyone knows someone, or knows of someone, who has recently declared. Many of these individuals keep their house and their car. They seem to have access to credit (although in many cases what they actually have is a secured credit card—they put $500 in the bank and they get a card with a $500 "credit line"). And their friends and neighbors, not seeing the details of their life that bankruptcy disrupts, assume that bankruptcy is not the devastating situation they always thought. And there have been a number of high profile celebrity bankruptcies in recent years. I can't help but think that this sends a message to the public that the stigma of bankruptcy is fast disappearing.

Finally, these changes have revealed a flaw in the system itself. Our bankruptcy code allows individuals to choose the chapter they wish to file in, regardless of need. If shame won't keep the subgroup of filers who could pay from either filing, or from filing in the wrong chapter, Congress needs to establish a mechanism that will. It must be simple, fair and efficient.

Last year, we strongly supported the bill introduced by Mr. Gekas and Mr. Moran, H.R. 3150. It provided a very simple, up front needs-based formula that allowed the overwhelming majority of those who needed bankruptcy relief in Chapter 7 to have it with virtually no questions asked. But for that subgroup of filers, for those higher income individuals who would use Chapter 7 to push their debts onto others regardless of the filer's ability to pay, the up front, needs-based test would have said, "No. Pay what you can afford, and society will wipe out the rest."

If individuals made less than the median income, or couldn't afford to pay 20 percent of their unsecured debts, H.R. 3150 would allow them to file in Chapter 7 without question. On the other hand, if an individual could afford to pay 40 percent of what he owed, H.R. 3150 would require him to pay what he could afford and the court would wipe out the remaining 60 percent. We strongly urged Congress to adopt that approach.

The Senate took a different approach in S. 1301. It relied far more heavily on tweaks to the current system to address the problem. I believe that in some cases, that approach could work. Where their were individuals who owed large amounts to single creditors and had the ability to pay that amount, that creditor might undertake the risks of legal action to seek payment. But in most cases, and especially for companies like mine, it wouldn't work.

For retailers such as Boscov's, a typical balance on a Boscov's card for a customer in bankruptcy is approximately $500. A recover in a Chapter 13 proceeding might be 30 cents on the dollar. It would not make economic sense for Boscov's to spend hundreds or more dollars in an uncertain effort to move a petition from Chapter 7 to Chapter 13 to recover $150 at $3 a month. This is not to say that $150 isn't important to us. With tens of thousands of individuals filing for bankruptcy, those losses add up. It is just that the up front approach was far more efficient. This is why the National Retail Federation so strongly supported the simple, up front approach.

Congress reached a compromise last year. Congress abandoned the simple, up front approach for a more discretionary system. It added numerous provisions designed to ensure that child support obligations were the highest priority. It also added a number of Truth in Lending provisions. We support some of these changes. Others will make it more expensive or difficult for us to operate. Nevertheless, we believe that Congress should pass legislation consistent with the conference report of H.R. 3150.

In closing, on behalf of the National Retail Federation, we urge members of Congress to take swift legislative action to address the problems confronting the nation's bankruptcy system. Otherwise, in the not too distant future, we may find that among a large segment of our society, bankruptcy filings will become the rule rather than the exception. If we are not careful, the costs of the rising tide of discretionary filings may tax society's compassion for those in genuine need. We must not allow that to happen. I believe that it is imperative for Congress to pass common sense bankruptcy reform legislation this year, consistent with HR 3150, that is fair, simple, and workable.

Mr. GEKAS. We thank the gentleman. Now we interrupt this program to introduce to the body Senator Biden, who has a long history of involvement in the bankruptcy issues facing our Nation, and who is here not only as a part of the joint panel that we have produced for today's hearing, but also because he has a personal interest in introducing a witness. Senator Biden?

Mr. BIDEN. Mr. Chairman, thank you very much. I would like the record to show my personal history in bankruptcy does not mean I have ever filed. [Laughter.]

And I want to assure Mr. Nadler I haven't switched sides. It was the most convenient seat.

Thank you, Mr. Chairman. I know you know the absence of Senators here in this joint hearing is because we have 11 votes in a row stacked. But I did want to come over, I know several of my colleagues have been here, because I'm particularly glad to have

the opportunity to introduce Mr. Bruce Hammonds, the senior vice chairman and chief operating officer of MBNA.

MBNA is headquartered in my hometown, Mr. Chairman, and is one of Delaware's most important and responsible corporate citizens, and, quite frankly, one of our largest employers in the State.

And I just want to state for the record that Senator Grassley and I, as you well know, Mr. Chairman, have been working closely on the Senate side to craft a piece of bankruptcy legislation that we believe can stand the test that you do not have to stand over here called a filibuster. And stand the test of bipartisan support. I'm sure it will be different to some degree from what the House reports out, but it is my hope that everyone recognizes there is a need for serious reform of the system. And Senator Grassley, myself, and Torricelli and others on the Judiciary Committee are trying to duplicate the outcome we had last year as it related to the vote count anyway to make sure we have an overwhelming vote in the Senate side.

So I look forward to working with you and all of our colleagues in the House Judiciary Committee to see if we can come up with a serious piece of legislation that addresses the problems. It will not be, as we say, all everyone wants, but I do think there's an urgent need for us to move. And I might add we've been told by the leadership on our side, Mr. Chairman, that if we don't get something moving on our side in the very near term, we are not going to have it brought up this year. Now that is not your problem, that's our problem. But we're working very hard at it.

And the last thing I'll say, Mr. Chairman, I always enjoy coming over to the House Judiciary Committee. For years and years of having chaired the Senate Judiciary Committee, I've envied you in a number respects, one of which is your platform is so much higher than ours. [Laughter.]

I always feel so much more important when I'm here than when I'm in the Senate side. But I realize I'm taken as seriously here as I'm there, so it's probably better I go back and vote.

But thank you very much, gentlemen and ladies, for the interruption.

Mr. GEKAS. By all means. We thank you for your participation, brief as it has been. And we'll keep you posted, which is a segue into an announcement by the Chair that the Senate practice and many times a House practice is that the witnesses who appear acknowledge and are willing to submit answers to questions, written questions posed by members of the panel, be it from the Senate or the House side. I assume by your presence here that you're willing to answer such questions. You can report to your colleagues that any written questions submitted will receive answers.

Mr. BIDEN. I thank the entire panel. Thank you, Mr. Chairman.

Mr. GEKAS. By all means. We now proceed to the testimony of Mr. Hammonds, if he can live up to all of this.

STATEMENT OF BRUCE L. HAMMONDS, SENIOR VICE CHAIRMAN AND CEO, MBNA AMERICA BANK, N.A., WILMINGTON, DE

Mr. HAMMONDS. I don't know. Thank you, Senator.

Mr. Chairman and members of the subcommittees, my name is Bruce Hammonds. I'm senior vice chairman and chief operating of-

ficer of MBNA America Bank, a national bank, which is the third largest credit card lender in the world. I appreciate the opportunity to appear today before the subcommittees.

The skyrocketing rise in consumer bankruptcies has impacted nearly every lender, large and small, in every segment of the lending community. In fact, more than $40 billion in consumer debt, about $400 for each American family, was erased as a result of bankruptcy in 1998. This underscores the fact that while bankruptcy is an important protection for debtors who need it, today's system lacks adequate concern for the great majority of Americans who continue to pay their debts and who ultimately bear the cost of bankruptcy losses in the form of higher prices for goods and services.

The current bankruptcy system needlessly harms everyone because of a fundamental flaw: it allows a debtor to discharge debts even if the debtor can repay some or all of those debts. In fact, today, a debtor may discharge his or her debts without ever demonstrating actual need for such relief.

To address this flaw, the Bankruptcy Code must be amended so that a debtor who needs bankruptcy protection will receive it, but only to the extent of that need. This is essential to ensure fairness for consumers and creditors alike. We believe that a need-based bankruptcy approach of the type contained in H.R. 833 would efficiently and fairly implement the kind of needs-based bankruptcy that is necessary. Such an approach would establish clear, objective standards for determining a debtor's repayment capacity.

These standards are as follows. If the debtor can pay all of his or her secured debt payments, priority debts, and living expenses, and still have sufficient remaining income to repay a portion of unsecured debts, the debtor will be required to enter into a chapter 13 repayment plan. If the debtor cannot repay, the debtor could freely choose to fall under chapter 7. Needs-based bankruptcy also would assign debtors to the appropriate chapter, that is to chapter 7 or to chapter 13 at the start of the bankruptcy case. This would drastically reduce the number of costly and needless disputes that occur in today's system.

This brings me to an important point, needs-based bankruptcy would create enormous efficiencies. It would actually reduce the overall cost of consumer bankruptcy by decreasing the litigation and disputes that result from today's system. A needs-based system would largely run itself. The vast majority of cases would move routinely through the system and disputes would be limited to exceptional cases.

Without systematic needs-based bankruptcy relief, the system will continue to be arbitrary, wasteful, and unfair to the great majority of consumers who pay for the system, but don't use it. Unless this flaw is addressed, controversy about consumer bankruptcy will continue to intensify.

Finally, I would like to address several myths that you are likely to hear: one, is that the bankruptcy system is not broken. Instead, some say that credit cards are the real cause of the explosion in personal bankruptcies. This claim is absolutely false. The evidence does not support it. More than 96 percent of credit card accounts pay as agreed and only about 1 percent end up in bankruptcy.

Bank card debt comprises less than 16 percent of total debt on the average bankruptcy petition. And in 1997, a Federal Reserve Board survey found that credit cards account for a mere 3.7 percent of consumer debt. Obviously, those figures are not large enough to be the cause of the bankruptcy crisis.

Another myth is that lenders are offering credit willy-nilly to people who cannot handle it. Once again, this simply is not true. Card issuers use sophisticated underwriting techniques to ensure that those who receive credit offers have a demonstrated ability and willingness to repay their debts.

Let me tell you how we do it at MBNA. When we receive a customer application, we pull a full credit card and do a debt to income analysis. We call back over 20 percent of the customers to obtain additional information. Then an analyst makes a decision to approve or decline the account. If it is approved, a risk rating is applied and often a senior lender sign-off is also required. We believe we are making the right decision every time. In fact, the majority of bankruptcies in our file are on customers who have been with us for more than 3 years.

I thank the subcommittees for the opportunity to present these views, and I would be happy to answer any questions you may have.

[The prepared statement of Mr. Hammonds follows:]

PREPARED STATEMENT OF BRUCE L. HAMMONDS, SENIOR VICE CHAIRMAN AND CEO, MBNA AMERICA BANK, N.A., WILMINGTON, DE

Chairman Gekas, Chairman Grassley and Members of the House and Senate, my name is Bruce L. Hammonds and I am Senior Vice Chairman and Chief Operating Officer of MBNA America Bank, N.A. ("MBNA"), headquartered in Wilmington, Delaware.[1] My responsibilities include overseeing MBNA's credit, loss prevention, customer satisfaction, consumer finance and loan review activities. I have 29 years of experience in consumer lending, and have been a member of the MBNA management team since 1982.

I appreciate the opportunity to appear today before this joint hearing of the Commercial and Administrative Law Subcommittee of the Committee on the Judiciary, United States House of Representatives, and the Administrative Oversight and the Courts Subcommittee of the Committee on the Judiciary, United States Senate (the "Subcommittees"), to discuss our views on consumer bankruptcy issues. I hope that this statement will be helpful to the Subcommittees in your deliberations on the nature of the consumer bankruptcy reforms that are presently needed.

OVERVIEW

Despite an extraordinarily strong economy, personal bankruptcy filings in the U.S. have skyrocketed in recent years. During 1998, an all-time record 1.4 million personal bankruptcy petitions were filed, which represents about one for every 100 households nationwide. By comparison, the number of consumer bankruptcy filings in 1980 totaled 287,570. This means that the number of consumer bankruptcy filings in 1998 *represents an increase of nearly 400% since 1980*.

These bankruptcy filings generate huge losses. While MBNA's credit card losses have consistently been among the lowest in the business, this precipitous increase in the number of consumer bankruptcy filings has impacted virtually every lender, large and small, in nearly every sector of the credit granting community. In fact, it is estimated that more than $40 billion in consumer debt—approximately $400 for each American family—was erased as a result of bankruptcy in 1998. Inevitably, these losses are passed on to all consumers in the form of higher rates and higher prices for goods and services.

[1] MBNA America Bank, N.A., a national bank, is the largest independent credit card lender in the world and one of the three largest credit card lenders overall. MBNA America Bank, N.A. and its subsidiaries have $60 billion in managed loans outstanding and almost 20,000 employees in 28 offices located in the U.S., the United Kingdom and Canada.

Despite the magnitude of these losses, bankcard issuers and the credit granting community more broadly believe that bankruptcy is an important protection for consumers who are severely overburdened financially. It should be noted, however, that as bankruptcy losses grow, it is those American consumers who continue to pay their debts who ultimately suffer the most because it is they who bear the cost of bankruptcy losses in the form of higher credit prices. Consumers also are harmed by increased bankruptcies when creditors, in an effort to reduce losses, tighten their credit standards and thereby decrease credit availability. As the Congress considers reform of the Federal bankruptcy system, it is critically important to keep in mind the adverse consequences bankruptcy has on the vast majority of consumers who continue to pay their debts. The basic requirements of fairness demand that a balance be restored between the interests of these consumers and the interests of those consumers who need bankruptcy relief.

THE FUNDAMENTAL FLAW

Unfortunately, today's consumer bankruptcy system does not strike that balance. The current bankruptcy system unnecessarily harms consumers and creditors alike because of a fundamental flaw—*it allows a debtor to discharge debts even if the debtor can repay some or all of those debts.* In fact, under the current Bankruptcy Code, an individual debtor may obtain a discharge from contractual debt obligations without ever demonstrating actual need for this relief. To put it in context, this means that in 1998 alone, the Federal consumer bankruptcy system provided an estimated $40 billion of relief to debtors without either objective standards or systematic procedures for determining the actual relief needed by debtors.

This flaw undermines not only the integrity of the U.S. bankruptcy system, but also traditional obligations of individual responsibility. Moreover, the current bankruptcy system also fails the debtors it is intended to help, because it provides short-term relief without helping debtors avoid the same financial failure in the future. In short, the lack of objective and systematic procedures for determining debtor relief produces a bankruptcy process which, for both debtors and creditors, is needlessly costly and time consuming. The bottom line is that this flaw must be remedied if the consumer bankruptcy system is to be workable and fair to consumers and creditors alike.

FAIR, EFFECTIVE NEEDS-BASED BANKRUPTCY REFORM

To address this flaw, the Bankruptcy Code must be amended so that a debtor who needs bankruptcy protection will receive it, but only to the extent of that need. This approach would match the bankruptcy relief provided by the Code to the debtor's actual need and is essential to ensure fairness for all parties impacted by the bankruptcy process. Bankcard issuers believe that a needs-based approach of the type contained in H.R. 833, a bill introduced by Chairman Gekas and Congressman Boucher with over thirty bi-partisan original co-sponsors, would efficiently and fairly implement the kind of needs-based bankruptcy approach that is necessary. We are joined in our strong support for this reform by representatives of virtually every segment of the consumer credit granting community.

The reformed Bankruptcy Code should establish clear and objective standards for determining a debtor's repayment capacity. These standards are as follows: if the debtor can pay all of his or her secured debt payments, priority debts and living expenses and still have sufficient remaining income to repay some portion of his or her unsecured debts above a statutory minimum, the debtor would be required to repay that portion through a Chapter 13 repayment plan, if the debtor seeks the protection of the Bankruptcy Code. If the debtor cannot repay, the debtor could freely choose to file under Chapter 7.

Moreover, a needs-based system would assign debtors to the appropriate chapter—that is, to Chapter 7 or to Chapter 13—at the start of the bankruptcy case. This would drastically reduce the number of costly and time-consuming disputes that occur in today's system, in which a debtor's Chapter 7 filing usually may be challenged only after the case is well under way and only through a separate judicial procedure. Once the needs-based bankruptcy system is established, the Federal bankruptcy system will largely run itself and disputes will be limited to exceptional cases.

SYSTEMATIC NEEDS-BASED BANKRUPTCY CREATES ENORMOUS EFFICIENCIES

This brings me to a very important point. While fundamental fairness alone dictates that a needs-based bankruptcy system be adopted, it should be noted that its implementation also would *introduce enormous efficiencies into the bankruptcy system*. A needs-based bankruptcy approach would actually reduce the overall costs of

consumer bankruptcy by decreasing the litigation and disputes that result from today's arbitrary bankruptcy system. Under such an approach, based on a simple calculation which is easily verified by the trustee, individuals who can repay some portion of their debt would automatically enter a Chapter 13 repayment plan, and those who cannot would be free to enter into Chapter 7. As noted above, a needs-based bankruptcy system would largely run itself: the vast majority of bankruptcy cases would travel routinely and efficiently through the system, and disputes would be limited to exceptional cases.

Without systematic needs-based bankruptcy relief, the U.S. bankruptcy system will continue to be arbitrary, wasteful and fundamentally unfair to the great majority of consumers who pay for the system but do not use it. Unless this flaw is addressed, controversy surrounding consumer bankruptcy will intensify, not diminish.

SEVERAL MYTHS

Finally, I would like to take a moment to address a couple of myths that you are likely to hear repeated, possibly today and certainly in the coming months. One is that bankruptcy reform legislation is unnecessary because the system is not broken. Some will claim that credit cards are the real cause of the explosion in personal bankruptcies, and that restricting the availability of credit through credit cards would solve this nation's bankruptcy crisis. I understand that for many this is a tempting and popular position, but it is false. The evidence simply does not support such a contention.

Instead, let's look at the facts. More than 96% of credit card accounts pay as agreed, and only about 1% end up in bankruptcy. Moreover, bankcard debt represents less than 16% of total debt on the average bankruptcy petition and, according to a 1997 Federal Reserve Board survey, credit cards account for a mere 3.7% of consumer debt—hardly large enough figures to be the cause of the bankruptcy crisis.

Another popular myth is that credit grantors are intentionally offering credit willy-nilly to people who cannot handle it. Once again, this contention simply is not true. Card issuers use highly sophisticated and expensive "prescreening" underwriting techniques, which involve consideration of as many as hundreds of factors about a consumer, to ensure that consumers who receive "pre-approved" offers of credit have a demonstrated ability and willingness to repay their debts.

Let me tell you specifically how we do it at MBNA. MBNA is the second largest lender through credit cards in the world. We receive an application from every customer, pull a full credit report on that customer, and do a debt-to-income analysis. We call back over 20% of the customers to develop additional information. A credit analyst will then make a decision to approve or decline the account. If the account is approved, a risk rating is applied and, in many cases, a senior lender sign-off is also required. We believe we are making the right decision every time. The majority of bankruptcies in our file are on customers who have been on the books for more than three years and have had some significant change in their financial condition.

The fact is, the overwhelming majority of Americans use credit wisely and successfully. Americans use their cards to pay at the gas pump, the grocery store and literally millions of other places. With the advance of on-line security systems, consumers are increasingly using their cards to conduct business and make purchases over the Internet. And credit has made opportunities available for millions of Americans who might not otherwise have had them, across a huge range of income levels.

In addition, the lending industry spends millions of dollars every year on education programs designed to help consumers use credit wisely. The bankcard industry works particularly closely with the more than 1,200 Consumer Credit Counseling Services offices around the country, which help many thousands of consumers get control of their finances and repay their debts. We are proud of the lending community's far-reaching efforts to inform, educate and assist consumers.

Once again, I want to thank you for the opportunity to appear before you today. Please let me know if we can be of any further assistance to the Subcommittees or their staff.

Mr. GEKAS. We thank the gentleman. And we turn to Judge Kenner for the proscribed 5 minutes?

STATEMENT OF CAROL J. KENNER, U.S. BANKRUPTCY JUDGE, DISTRICT OF MASSACHUSETTS, BOSTON, MA

Ms. KENNER. Thank you, Mr. Chairman, and members of the subcommittee. My name is Carol Kenner. I've been on the bank-

ruptcy bench for 12 years. During that time, I've presided over approximately 35,000 bankruptcies. And I'm honored to be here today.

The current Bankruptcy Code on the whole is a well-balanced, well-conceived statute, given that it must arbitrate and balance the diverse needs of creditors, debtors, and others. I think it works remarkably well. It is a law that Congress should be justifiably proud of because it provides an effective mechanism for paying dividends to creditors while affording debtors a fresh start. It does provide an essential safety net for American families and individuals who have hit hard times. And these hard times can be a job loss. They can be divorce, separation, health problems, and other causes. But the people I see on a day-to-day basis are compelled to file bankruptcy because of those reasons. I'm not suggesting that the law is perfect, but I think it only needs to be fine-tuned.

I would like to focus on the subject of reaffirmation agreements because I think this is an area where Congress may want to consider making some changes. A reaffirmation agreement is an agreement between a debtor and a creditor whereby the debtor agrees to pay part or all of the debt that would otherwise be dischargeable. Congress put some safeguards in the law to make sure the debtors didn't reaffirm debts imprudently and without fulling understanding what they're doing. Unfortunately, some of those safeguards I believe aren't fulfilling the goals the Congress designed them for.

For example, today a reaffirmation agreement only requires court approval if the debtor's attorney doesn't sign the affidavit saying that he has explained to the debtor all of his rights. But the affidavit procedure isn't working. In fact, it drives a wedge between the debtor and his counsel because what typically happens, as I see on a day-to-day basis, is that the debtor says, "I want to reaffirm the debt on my washing machine and in order to do that, I've got to pay the $300 value of the washing machine." The lawyer says, "You can't afford this." The client says, "Sign here, please." And that reaffirmation agreement escapes scrutiny of the bankruptcy court.

I think all reaffirmation agreements should go before the bankruptcy judge. And I know that that's going to put a burden on me and my colleagues, but it's a burden I think we must bear because it has such a substantial impact on whether the bankruptcy system fulfills its goals.

Another way that reaffirmations have to be re-looked at is I think debtors have to know what the bottom line cost is. They come before me and they say, "I want to reaffirm a debt on this gas grill that's currently worth $100." But they're going to pay for it over time in increments of maybe of $10, $15. The bottom line is that the cost of that gas grill might very well be $500 and the debtors don't understand what they're getting into.

Sometimes debtors reaffirm debts in the mistaken belief that it will provide them with a line of credit in the future and that otherwise it will be difficult or impossible after bankruptcy to obtain that credit line. That's simply inconsistent with my experience.

My time is short, but I think the treatment of secured debt requires some special attention. And I think that Congress needs to

examine whether there is truly a secured debt interest in a household good, such as a mattress or a baby crib. Because if the creditor is going to repossess the baby crib only to take it to the town dump, then I think we need to re-examine the protections that we're providing for American families.

As you consider the Bankruptcy Code revisions and these questions, I ask that you address these concerns.

Thank you.

[The prepared statement of Judge Kenner follows:]

PREPARED STATEMENT OF CAROL J. KENNER, U.S. BANKRUPTCY JUDGE, DISTRICT OF MASSACHUSETTS, BOSTON, MA

Mr. Chairmen and members of the Subcommittees, my name is Carol J. Kenner. I have served as a United States Bankruptcy Judge for the District of Massachusetts for the last 12 years and during that time presided over more than 35,000 bankruptcy cases. I am honored to be here today.

The current Bankruptcy Code, on the whole, is a well-balanced and well-conceived statute, given that it must arbitrate and balance the diverse needs of creditors, debtors and other constituencies. It works remarkably well. It is a law that Congress should be justifiably proud of because it provides an effective mechanism for paying dividends to creditors while affording debtors a fresh start. My purpose today is to offer observations, gleaned from daily administration of this law over the last twelve years, as to whether, in practice and with respect to discrete concerns, the current law is fulfilling the goals that Congress intended.

I would like to focus on the subject of reaffirmation agreements. A reaffirmation agreement is an agreement between a debtor and a creditor where the debtor agrees to pay a debt that would otherwise be entirely or partially discharged in the debtor's bankruptcy case. When Congress enacted the Bankruptcy Code, it sought to protect financially-burdened families seeking chapter 7 relief from compromising their fresh start by making unwise agreements to pay dischargeable debt.

For example, suppose the debtor files a chapter 7 case. At the meeting of creditors, a Bank creditor or credit card company asks the debtor if he wants to reaffirm his $3,000 unsecured debt in exchange for the Bank's agreeing to let him keep the credit card after the bankruptcy. By reaffirming the $3,000, the debtor is giving up his right to discharge that debt.

The reaffirmation agreement REVIVES the legal enforceability of the debt. So when a debtor chooses to reaffirm a debt, that agreement negates one of the primary goals of bankruptcy: giving the debtor a fresh start and enabling him or her to resume a role in the economic mainstream. Instead of exiting bankruptcy with a fresh start, the debtor remains liable on a debt that otherwise would have been wiped out.

Congress very wisely established safeguards that are intended to insure that debtors do not reaffirm debts imprudently and without full understanding of what they are doing. Most notable among these is the requirement that, before a reaffirmation agreement can become effective, the debtor's attorney must certify, or (if the debtor is not represented by counsel or counsel refuses to make the necessary certification) the Court must find, that—

1. the agreement represents a fully informed and voluntary agreement by the debtor;
2. the agreement does not impose an undue hardship on the debtor or a dependent of the debtor; and
3. the debtor has been fully advised of the legal effect and consequences of—
   (i) a reaffirmation agreement and
   (ii) any default under such an agreement.

As paternalistic as this safeguard may sound, experience demonstrates that it is necessary. Unfortunately, for various reasons, the present safeguard is not enough. The current law on reaffirmation agreements often does not fulfill the goals that Congress intended.

Debtors often make the decision to reaffirm (1) without understanding the legal effect of what they are doing, (2) without understanding its financial cost, and (3) without understanding their alternatives. Often, they must make the decision in intimidating circumstances. Often the creditor is suddenly threatening to repossess a necessary asset that the debtor can't afford to replace—such as the car they need

to get to work or their family refrigerator. Debtors tell me that they feel intimidated by having to appear for their meeting of creditors (many reaffirmation agreements are obtained at the meeting of creditors) and by the creditor seeking the reaffirmance. Often they have no advance warning that they will have to face this issue. And often their attorney is not with them when the creditor approaches, if they have an attorney at all. Although the current statute gives debtors time to rescind agreements made imprudently and requires that the agreement advise the debtor of this option, the creditor does not leave a copy of the signed agreement with the debtor, so the debtor does not know of his or her option to rescind.

Another problem is that the requirement of the attorney declaration can drive a wedge between the attorney and client. The attorney may recognize that the client can't afford to pay the monthly charge, yet the client insists that the car or refrigerator is essential. Understandably, very few attorneys resolve this tension by standing firm against the client; most simply facilitate the client's decision to reaffirm by providing the necessary declaration.

Congress may want to consider the following:

a. Today, a reaffirmation requires court approval only when the reaffirmation agreement is filed without an affidavit from the debtor's attorney. I believe Congress should consider requiring court approval for ALL reaffirmation agreements. I recognize that such a provision would place a burden on bankruptcy judges, but this is a burden I am willing to bear because it has such a substantial impact on whether our bankruptcy system fulfills its goal of providing debt relief to needy individuals and families.

b. The financial impact of reaffirming a debt should be absolutely clear. Debtors need to know the principal amount of the debt, the interest rate, and the liquidation value of the collateral; and, most importantly, they need to know the bottom-line cost. Debtors need the same kinds of disclosures that Congress requires in the Truth-in-Lending law.

c. Sometimes a debtor reaffirms an unsecured debt in the mistaken belief that it will permit him to obtain a line of credit in the future and that, otherwise, it will be difficult or impossible for him to obtain credit. This belief is inconsistent with my experience. Debtors' attorneys tell me that their clients are obtaining credit post-bankruptcy quite easily. And debtors can certainly use debit cards or secured credit cards if they need a card.

d. Sometimes a debtor reaffirms a debt in response to a complaint by the creditor that the debt is nondischargeable on account of fraud. The best place for the Court to evaluate the merits of the reaffirmation agreement is in the context of an adversary proceeding to determine the dischargeability of the debt.

e. The treatment of secured debt requires careful thought. A debtor who wants to keep household goods or his car needs to understand what his options are. Most don't appreciate that one of the options is redeeming the collateral. But, realistically can a debtor redeem the collateral, such as a car, by paying the creditor the current value of the car in cash, in one lump sum payment? Most debtors I hear from can't do so. They would have great difficulty in making lump sum payments—they live from hand to mouth, paycheck to paycheck. They could perhaps redeem over time—perhaps 6 months—but they simply cannot do so in a lump sum without taking food off the table for the family.

f. Sometimes a debtor reaffirms a debt where the collateral is a household item such as a mattress or a crib. In those cases, there is rarely a market for such used goods and, as a practical matter, the likelihood that the creditor will foreclose is remote. I have trouble understanding why the creditor should be permitted to repossess the mattress and then merely cart it to the city dump.

g. Proposed section 125 of H.R. 833 (formerly H.R. 3150) is problematic because it defines the value as the price a retail merchant would charge for property of that age and condition—but in fact there is rarely a market for such used household goods.

h. The debtor needs to be given a copy of the executed reaffirmation agreement in order to better enable him or her (1) to reconsider the agreement and (2) to know of the option to rescind.

i. If the debtor is reaffirming a debt that is entirely unsecured, the debtor should state why he or she is doing so.

j. Sometimes a debtor reaffirms a debt in response to a creditor's threat to bring a nondischargeability action. In some cases there is little or no basis for such a suit. In order to evaluate whether that reaffirmation agreement is reasonable, the Court needs information from the parties. Many families in bankruptcy simply cannot afford to defend against claims of nondischargeability.

k. Sometimes the debtor reaffirms an unsecured debt because his mother-in-law co-signed the loan and he wants to protect the guarantor. I can't understand why such a reaffirmation would ever be in the debtor's interest: nothing prevents him from *voluntarily* paying a debt that's been discharged in order to keep peace in the family, but he need not legally bind himself on the debt in order to do that.

As you consider the Bankruptcy Code and the need for reform, these are the concerns I would have you address. Thank you for your consideration.

Mr. GEKAS. We thank the Judge and we'll return to her during the question and answer period.

Mr. Nuss.

STATEMENT OF LARRY NUSS, CEO, CEDAR FALLS COMMUNITY CREDIT UNION, CEDAR FALLS, IA, REPRESENTING THE CREDIT UNION NATIONAL ASSOCIATION, INC.

Mr. NUSS. Good afternoon, Chairman Gekas and members of the subcommittees. I am Larry Nuss, CEO of Cedar Falls Credit Union in Cedar Falls, Iowa, and I very much appreciate the opportunity to be here to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions. I am speaking on behalf of the Credit Union National Association, CUNA, which represents over 11,000 State and Federal credit unions nationwide. Our credit union is a $33 million State-chartered, Federally insured credit union.

Along with other creditors, credit unions are experiencing an increase in bankruptcy filings with almost half of all credit union losses due to bankruptcy. Cedar Falls Community has seen a significant increase in chapter 7 bankruptcy filings which cause the greatest loss to the credit union. I refer you to my full written statement for the statistics.

Credit unions clearly recognize the value of financial counseling for their members, such as a consumer credit counseling service. However, even with financial counseling, we certainly recognize that there are some instances in which bankruptcy may be the only alternative for members, the way for them to get the needed fresh start.

Credit unions want to help their members avoid financial difficulty through learning to manage their credit. More emphasis should be placed on consumer financial education so people can learn how to manage credit and what the alternatives to bankruptcy are. Therefore, CUNA strongly supports the provision in H. R. 833 requiring the debtor to receive credit counseling prior to filing for bankruptcy and prohibits the chapter 7 or 13 debtor from receiving a discharge if the debtor does not complete a course in personal financial responsibility.

We also support the provision in the bill that requires a consumer debtor to be given a notice about bankruptcy and a description of credit counseling services. Any sensible bankruptcy reform should include education provisions so debtors have the tools to make wise decisions about filing for bankruptcy and to succeed fi-

nancially after bankruptcy. Therefore, we support the sense of Congress in H.R. 833 that each of the States should develop curriculum on personal finance for elementary and secondary schools.

Credit unions are currently going into their local schools and teaching students about money management. For example, in the 1997, 1998 school year through the National Youth Involvement Board, which is a network of credit union volunteer professionals, they visited classrooms across the country to educate students about the wise use of credit, savings options, budgeting, and careers.

I have provided the committee members with a copy of a CUNA publication, *savingteen*, which highlights financial literacy in youth and I would ask that this publication be submitted for the record.

Mr. GEKAS. Without objection, it will be entered into the record.

[The information referred to follows:]

Credit Unions and Youth Education
savingteen
A Supplement to Credit Union Magazine
Education
is our Future
Our Vulnerable Youth:
The Financial Literacy of
American 12th Graders –
A Failure by any Measurement
Meet the
"Millennials"
Coke or Pepsi?
Bank or Credit Union?
Redesigning Your Services
for Young Members
Cats, Dogs,
or Kangaroos?
"FREE MONEY
ON CAMPUS!"
The Birds and the Bucks:
Bringing the Facts of Finance
into the Classroom
Resources

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With these youth marketing and education materials from CUNA & Affiliates (quantity discounts available on all):

Teaching Teens About Money Kit ($18 each)
Donate this book of classroom exercises and worksheets to the schools near your credit union. It offers basic information on spending, saving, checking, credit, insurance, smart shopping, investing, credit unions, and credit union careers. (stock no. 21607, 144 pages)

Guide to Money: Getting a Good Start ($45/50)
Give this booklet to young members to promote smart money management and use of credit union services. (stock no. 20769, 24 pages, formerly titled "A Teen's Guide to Money")

Teach Children about Money ($14/100)
This statement stuffer brochure offers suggestions for helping kids become regular savers and responsible borrowers. (stock no. 20873)

Save, Spend, & Share ($25/50 books)
Give this engaging 16-page coloring book to kids entering your credit union. It promotes good financial habits and a positive credit union image. (stock no. 21323, 16 pages)

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CUNA & Affiliates

Education is Our Future

by Daniel A. Mica,
President/CEO,
CUNA & Affiliates

A politically charged 1998 has left a variety of questions and challenges in its wake. Not the least of which was directly generated by the success of the credit union movement in achieving passage of H.R. 1151. We've secured the legislative future of credit union membership. But can we now sit back and feel like our job is done? No, we can't. Not when credit unions' future security and prosperity depends on other factors besides legislation. Consider that:

- Our membership is graying. The average age of credit union members is in the mid-forties. How do we replace these members?
- Increasing rates of bankruptcy, particularly among young people, threaten the ability of consumers to afford credit, and of credit unions to provide service at reasonable prices. Bankruptcy is directly attributable to a lack of financial knowledge and sophistication on the part of consumers. What must we do to help our young members gain the knowledge they need to avoid bankruptcy?
- Most people choose their primary financial institution by age 25 and stay with it, on average, for 15 years. Credit unions have the lowest membership penetration rate in the 18-24 age group, the years this PFI decision is being made. How do we increase our youth penetration rate?

Today's world places a great deal of economic power in the hands of children, both directly and through influence on their parents' spending and saving habits. To ignore this reality is not only negligent on our part, it would be in conflict with our mission and history. The challenge of "raising" financially aware, responsible members should be one we relish and go after with enthusiasm.

We must also keep in mind that our success politically adds urgency to our responsibility to young members. The textbook success and unprecedented response generated by the Campaign for Consumer Choice has positioned credit unions prominently on the radar screens of national media, Congress, the Administration, and of course, bankers.

All of these groups will be looking at us to "walk the talk" we broadcast about our uniqueness and commitment to our membership during the process of lobbying for H.R. 1151. Challenges to our operations and to our tax status seem sure to come. We must be ready, not only through our rhetoric, but through concrete examples of how and what we do. Youth education is a tremendous opportunity for us to meet these potential questions with exceptional examples of our commitment.

This supplement is devoted to looking at the issues surrounding credit unions and youth education because quite literally our future depends on it. And what kinds of information are young people in need of from credit unions? Here are some examples:

- The importance of saving.
- How to budget.
- Strategies for shopping to maximize purchasing power.
- The wise use of credit.

We have a unique opportunity to affect not only the future of credit unions, but also the future and economic well being of the nation through educational efforts that produce financially literate adults. Credit unions strive to be champions of the consumer. Making youth financial education a priority is one important way to continue fulfilling that role. ♦

Our Vulnerable Youth:

The Financial Literacy of American 12th Graders – A Failure by any Measurement

by Lewis Mandell, Ph.D.

America's young adults are leaving school without the ability to make critical decisions affecting their lives. This finding, from an historic benchmark study of graduating high school seniors, may help explain a number of distressing recent phenomena including record numbers of personal bankruptcies. Moreover, those high school seniors with lower educational aspirations know substantially less than the dismal amount known by their college-bound counterparts.

These findings come from the 1997 Personal Financial Survey, which was administered to 1,532 high school seniors from 65 high schools throughout the United States. Overall, students correctly answered just 57.5% of the 31-question multiple-choice examination, which was designed by a team of educators to test basic financial survival skills (Fig. 1.). More shocking is the fact that only 10.2% of the students scored a "C" (75% correct) or better on the exam.

That students were able to choose correct answers, on average, slightly more than half the time was due in large part to a number of questions that tested terminology rather than reasoning ability. For example, 89.1% knew that salaries, wages, and tips constituted primary sources of income for most people age 20-35, but fewer than half suspected that if a person's income doubled (from $12,000 to $24,000 per year) income taxes would double, at least. The inability to apply the concept of income tax progressively hinders the decision-making ability of young labor force entrants who may tend to overextend themselves in terms of consumption and debt in anticipation of inflated future take-home pay.

The decision to test high school seniors was made because many graduates do not go on to college and formal education ends for them in the 12th grade. In addition, relatively few college students study personal finance, making primary and secondary schools the only places where the vast majority of young Americans can acquire financial survival skills. However, according to the survey results, only 11% of students replied that they learned about managing money primarily at school and *their test failure rate* was higher than that of the majority of students who learned most at home from their families and nearly as bad as the failure rate of students who learned mainly from peers (Fig. 2).

Furthermore, students from states that mandate the teaching of consumer education and personal finance do no better, and perhaps worse, than students from states lacking mandates. These findings imply that the schools that are teaching tools of money management may need some

Figure 1
Sample survey question (#25)

Only one of three participating high school seniors correctly answered the following question. Roughly equal numbers of respondents chose the three incorrect answers (a, b, and c).

Sarah must borrow $10,000 to complete her college education. Which of the following would NOT reduce her finance charge rate?

a) If her parents cosigned the loan.

b) If her parents took out an additional mortgage on their house for the loan.

c) If the loan was insured by the Federal Government.

d) If she went to a state college rather than a private college.

strengthening of their curricula.

A consistent result found by examining answers to individual questions in the survey is that actual experience in managing one's finances does little, if anything, to improve financial literacy, even in areas directly affected by experience. Students who use credit cards know no more about them than students who don't use them and those who pay auto insurance don't understand it better than those who don't drive or whose parents pay the insurance. In fact, experience, unaccompanied by some type of broader theoretical or contextual education, may be worse than no experience at all because it often misleads young people about financial relationships that they will encounter when they are on their own.

Questions were divided into four categories: income, money management, saving and investing, and spending and credit. By far, the weakest area of knowledge was saving and investing, where students answered only 47.4% of questions correctly. For example, only 14.6% of students felt that stocks would have a higher rate of growth over 18 years than savings accounts, checking accounts or U.S. Government savings bonds. In addition, 51.6% said that a certificate of deposit at the bank is not protected against loss by the Federal Government. Finally, fewer than one-third knew that interest earned on a bank savings account may be taxable if total income is high enough.

Women, on average, scored slightly higher than men (57.9% compared to 56.9%). However, 11.5% of male students scored "C" or better on the exam as compared with only 9.1% of female students.

Differences also existed for students of different racial backgrounds. The study was carefully designed to reflect the diversity of American 12th graders and, in fact, only 57% of the sample were White, who answered, on average, 60.9% of the questions correctly. Native Americans averaged 48.8%, African-Americans 50.4%, Hispanic Americans 55.1% and Asian-Americans 55.8%.

Contrary to expectations, differences in scores were not very dependent upon family income. Students with family incomes below $20,000 per year averaged 55.2% in contrast to the 59% for families in the over $60,000 bracket. In fact, average scores were slightly lower for students in the top income bracket than for those in the bracket below ($40,000 to $79,999) indicating, perhaps, that more-affluent, college-bound students were not as concerned than their less-affluent counterparts with personal survival skills. However, the 2% of students who planned no education beyond high school did markedly worse on the exam (45.8%) than did others.

Scores did vary somewhat by region of the country. Students in the Northeast and North Central regions did best with average scores of 59.6% and 59.0%, respectively, while students in the South and West did worst with scores of 55.8% and 55.3%.

One important finding of this study links low scores on the Personal Financial Survey to high rates of personal bankruptcy within the students' states. This finding holds out the possibility that the enormous costs of personal bankruptcy to the affected families and to the larger society may be reduced through increases in financial literacy (Fig. 3).

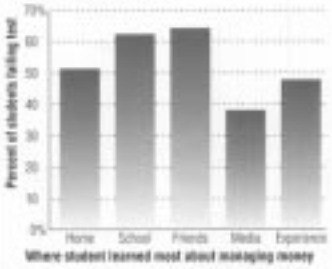
Students were asked to name the most difficult money management problems faced by people their age and also by adults who have families. The most frequently mentioned problem for their age group was spending on things that they really didn't need. This was followed by the problems of being able to save, particularly for college. For adults, problems of paying bills, budgeting, and supporting children were identified as being most severe.

The magnitude of the problems of financial illiteracy uncovered by this study greatly understates the true extent of the problem nationally for two reasons.

First, the sample included only high school seniors who will short-

Figure 2

Test failure rates and sources of financial knowledge



Note: A test score below 60%, or 13 of 21 questions wrong, indicates failure. From Dr. Mandell's 1997 Personal Financial Survey.

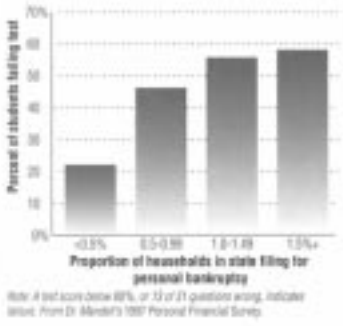
Students who use credit cards know no more about them than students who don't use them.

ly become high school graduates and did not include those who dropped out.

Second, even among high school seniors, the sample picked up only 2% who planned no additional education. This may relate to the request that high schools administer the test to 12th-grade classes in English or Social Studies other than Economics to avoid biasing study results. Since students who were not college bound did substantially worse than the others, the study may have omitted as many as one-third of all 18-year olds who will not graduate from high school or who plan no additional education and who would have caused a substantial decrease in the overall results. For this reason, the plan of the Jumpstart Coalition to encourage the teaching of financial literacy in K-12 grade levels is critical. ✦

Figure 1

Test failure rates and state bankruptcy rates



Note: A test score below 60%, or 13 of 21 questions wrong, indicates failure. From Dr. Mandel's 1997 Personal Financial Survey.

Dr. Mandel is dean of the school of management at State University of New York at Buffalo. The Jumpstart Coalition for Personal Financial Literacy is a group of more than 70 organizations, including CUNA, which promotes K-12 curriculum enrichment for teaching basic money management skills, and which sponsored Dr. Mandel's study. This article is excerpted with permission from the full 118-page report, "Our Vulnerable Youth," which is available for $14.95 plus shipping & handling by calling 202-466-8604 or by ordering online at www.jumpstartcoalition.org.

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Young member of State Employees Credit Union, Lansing, Mich., enjoys "Adventures in Savings," (see ad p. 6A). Her age group, 4 to 12, spends an estimated $24 billion a year.

Meet the "Millennials"

by Vicki Joyce

Look out, here they come! They're the "Millennial" generation, they're 70 million strong and a force to be reckoned with. Children ages 18 and younger comprise 28% of the U.S. population—an amount nearly equal to that of their Baby Boomer parents.

Problem is, most credit unions don't know they exist, or don't understand the market's full potential—now and when it matures. Like motherhood, everyone's in favor of serving the youth market. Nearly every credit union (96%) has a common bond that includes family members. But in practice only 23% of credit unions have a formal program for serving youth—the rest are merely paying lip service. The price these credit unions will pay will hit hardest when this market matures—and goes elsewhere for financial services.

To serve this market, it's imperative that you learn as much about it as possible.

Who Are They?

Today's youth share many of their parents' values and interests, and are said to be more optimistic, caring, respectful, and civic-minded than their predecessors, the notorious Generation X-ers. They are the first high-tech generation, born into a world of computers, cell phones, ATMs, and the Internet. As interactive consumers, they think and react differently than yesterday's youth. Over time, they'll be even more attuned to e-commerce in all shapes, sizes, and forms than any other market segment.

They are also more racially and ethnically diverse than previous generations, with a mere 66% non-Hispanic white population. At current rates, non-Hispanic whites will be in the minority after 2030. Because the Millennial Generation is a highly segmented market, businesses will have to use a variety of target-marketing strategies to reach them. Products, services, and customer-service representatives will need to reflect this diversity. Their technological skills will demand well-organized, informative, and interactive web sites. And their purchase decisions include the latest in home electronics.

More and more children (66%) now live in households with parents who work. As a result, children are forced to take on household responsibilities at an early age given parental time commitments and constraints, and are fast becoming savvy consumers.

Many Millennials have money to spend—and to save. According to a Rand Youth Poll, teens spent $84 billion in 1997, up 12% from 1996. That's an average of more than $3,000 per teenager, and roughly $60 per week. And ac-

cording to James McNeal, a marketing professor at Texas A&M University, the younger set—those aged four to 12 — had an additional $28 billion in income, of which they spent $24 billion (86%), and saved $4 billion (14%).

Yet given all this money, one can't forget that in 1996, 21% of U.S. children lived in poverty. This means that for every four children who have money to spend and save, there is one child who has none. So while credit unions can provide special savings vehicles for those with money to spend, they could also provide internships for those less-fortunate youth.

Kids derive their income from a number of sources, including parents on an as-needed basis, odd jobs, regular allowances, gifts, and part- or full-time jobs. Between 60% and 70% of children aged 6 to 17 receive a weekly allowance (see Fig. 1); and one-half of children aged 16 to 19 are employed, earning an average weekly wage of $247.

A Generation of Spendthrifts

Research indicates that at least two-thirds of children have an account at a financial institution, yet many are financially illiterate. Two-thirds of children aged 12 to 19 have a savings account, according to a 1996 Teenage Research Unlimited (TRU) survey. An additional two of 10 have a checking account, 16% own stocks/bonds, and 5% have mutual funds. And while that might suggest a level of financial sophistication that other generations didn't have, keep in mind that many are at a loss when asked what their balances are, to define the words "interest" and "dividend," or what happens when you don't pay your credit card balances in full. In fact, six of 10 preteens are unable to explain the difference between cash, checks and credit cards, according to the nonprofit National Center for Financial Education (see also "Our Vulnerable Youth," p. 4A).

Everyone's in favor of serving the youth market, but only 23% of credit unions have a formal program for doing so.

This financial ignorance has led the Consumers Union, a nonprofit research group concerned with helping people spend money wisely, to predict that the Millennials will be a generation of "spendthrifts" and "deadbeats." They fear that the current state of young people's financial literacy will lead to greater consumer debt in the future. Currently, just 26 states require consumer education courses, and only 14 of these require curricula to include personal finance. Yet research substantiates the fact that adults who receive some form of financial education as children save nearly 5% more money than those who do not receive such education. A case in point. A Merrill Lynch study found that adults save more than other adults when, as kids or teenagers, they:

- Took courses in school on household finances
- Had bank accounts
- Owned investment securities
- Received an allowance
- Held a regular job
- Communicated with parents about financial matters
- Had parents who saved.

Why should credit unions care about the youth market? Because they are the key to your credit union's future success. Young members should be viewed as future borrowers, not as insignificant savers. It's important to initiate them into the credit union movement now before they fall prey to other financial institutions.

Obviously there's room for improvement when it comes to converting this market as it matures into adulthood. *Credit Union Magazine*' 1998 National Member Survey shows a mere 25% of eligible young adults (aged 18 to 24) are credit union members. However, the vast majority (50 million) of children are, in fact, eligible to join a credit union. If more children become credit union members, this percentage will increase and so will your pool of future borrowers.

Serving this market requires no special tricks. It does, however, require resources like marketing, member education, and programs that target youth.

Don't delay, today's youth are a target market for your competitor—today, not tomorrow. •

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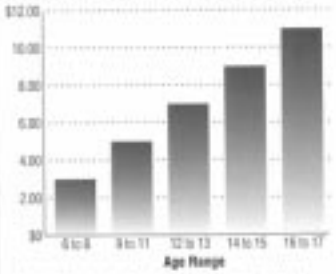
Figure 1
Average weekly allowance by age



Source: 1998 Generation Connect Shulman survey for Youth Monitor, a syndicated service of Nickelodeon

Illustration courtesy of Sovereign Bank. All rights reserved.

Coke or Pepsi? Bank or Credit Union?

by Lucy Harr

Every day consumers make choices based on brand preference. Every day marketers toil to create brand images that generate customer loyalty and build a competitive advantage. And the earlier those images are instilled, the better. Consequently, credit unions face an uphill battle in establishing brand loyalty: After all, not many kids have a "piggy credit union."

Many banks are working diligently to capitalize on that natural advantage by establishing and maintaining relationships with children and, through them, their parents.

Kids' Bank

In Broomfield, Colo., Eagle Bank (www.eaglebankcolorado.com) has eight "branches" in area elementary schools, each branch named for the school mascot. The banks open one half hour before school starts on designated days. Volunteer student bankers take turns throughout the school year as tellers and as specialists in new accounts, customer service, and information/advertising. There are currently some 370 accounts, with deposits ranging from $10 to several thousand, and averaging about $200, according to Mary Frances Crosswhite, educational specialist in charge of the program.

The Kids' Bank program includes loans as well. "To help students understand the process and the importance of dependable goals when getting loans, we have provided short-term loans to school classes," notes Crosswhite. For example, a first-grade class annually borrows money to purchase ingredients for baking cookies, which the students sell in school. After repaying the loan, the first-graders use the profits to support an endangered bird at a local sanctuary. Other loans have funded inventory for a school store and supplies for a craft sale.

Crosswhite, who's also known as the "bank lady," provides specific training for the student bankers as well as classroom instruction on banking-related subjects, such as money, banking procedures, and economics.

"I cannot emphasize enough that banking and saving are only part of this program. Without the dedication to education and the ongoing support in the classroom — a minimum of six hours a day, four days a week

— our Kids' Bank would not meet the needs of today's students," Crosswhite says.

"National Teach Children to Save Day"

Thousands of bankers across the nation go back to school each April as part a program developed by the American Bankers Association Education Foundation

> **"Teachers appreciate bankers providing first-hand knowledge."**

(ABAEF). This year "National Teach Children to Save Day" is slated for Tuesday, April 20, according to Kathryn Kelly, program director. Kelly notes that setting aside a day each year focuses many bankers' efforts. As a result, they subsequently may start a savings club or offer incentives for youth savings.

ABAEF provides a variety of program activities and lesson plans, including suggestions on adaptations for various age and ability levels. According to Kelly, the initial national day was designed for kindergarten through sixth grade, with new materials currently being developed for middle and high schoolers. The materials also support National Council of Teachers of Mathematics curriculum standards. (For more information about this program, see "Other Web Sites," p. 23A.)

"Teachers think it's great," says Cheryl McCollom, director of communications for the Wisconsin Bankers Association. "They appreciate bankers providing first-hand knowledge and the fact that students are hearing from someone else." According to Kelly, evaluations from teachers indicate 99% would recommend the program to a colleague. Feedback from kids also is uniformly positive. In Wisconsin some 110 banks—about one-third of the state's 340 banks—took part in "National Teach Children to Save Day" last year, a participation rate that earned an award from ABAEF. "It's catching on," says McCollom, "and we expect participation to grow even more."

ABAEF also is piloting a program called "In Charge," aimed at youth ages 15 to 22. "The materials are designed to help educate young people about credit," says Kelly. "We want them to start out on the right foot." ABAEF is testing "In Charge" in high school classrooms and with community and college groups in 10 states this year. (See "Other Web Sites," p. 23A.)

Virtual Classrooms

Banks' educational efforts extend into cyberspace as well. Pennsylvania-based Sovereign Bank launched *www.kidsbank.com* in June 1997. "The KidsBank.Com web site explains the fundamentals of money and banking to children in a uniquely fun and engaging way that invites the participation of the parents in the learning process," according to Sovereign's marketing director and senior vice president Mary L. Orlando.

The web site features four characters who explain various aspects of money and banking, interactive calculators, and an "Ask Mr. Money" bulletin board, devoted to children's questions. Christine Mitchell, project manager for Sovereign's Internet Technologies and one of the founding members of the KidsBank.Com Foundation, answers each question personally. Mitchell notes that KidsBank.Com is not selling any particular product. "It's a purely educational site," she says.

Hundreds of banks also use the web to promote youth accounts as well as to educate. Southern Community Bank and Trust (*www.sctrust.com*), Winston-Salem, N.C., for example, offers a money market savings account for minors. Its "Just for Kids" account has no minimum balance, no monthly fee, and up to six checks per month free. An online application makes it easy to sign up and the bank even makes a $2 initial deposit.

Kids who visit *www.commonwealthbank.com* learn that "Super Saver Sam" has a gift for them. When they report to any of Pennsylvania-based Commonwealth Bank's 58 branches they receive either a calculator or a coloring book. The site also offers information on Commonwealth's passbook savings account, described as "a special savings account that would be perfect for you."

According to Jenny Bavisotto, communications director for the Independent Bankers Association of America, most of their members have kids' accounts, although not all publicize them. "For some it's just standard operating procedure," Bavisotto notes. The IBAA encourages its members to develop account relationships early, and features an article on marketing to Generation X in its December 1998 issue of *Independent Banker*.

Whether it's with a classroom presentation or a colorful character on a web site, clearly, banks are reaching out to the youth market. By doing so, they're banking that brand awareness and loyalty will carry forward into the future, serving them well in their competition with credit unions. ♦

Lucy Harr is owner of Providing Solutions, a communications consulting firm based in Stoughton, Wis. She can be reached at 608-877-0133 or lharr@providing-solutions.com

Redesigning Your Services for Young Members

by Bonnie Miller

Youth programs earn money for credit unions and their members while building better relationships with them and preparing children to become loyal members in the future. Youth programs also contribute to community stability and build good will.

But it also makes sense to provide financial services to members under the age of 18 because they have a need. Figure 1 shows how your services can address the changing needs of young members.

As with any service expansion, you must establish specific policies and procedures to ensure that your youth program is a successful, worthwhile venture. The laws in your state and your credit union bylaws influence the features of specific accounts, such as age limits, credit card limitations, maximum loan amounts, lending terms, interest rates, credit requirements, co-signers, fee structures, and minimum deposits, as well as check card and ATM card limitations.

You must establish dollar authorization limits lower than those of your adult members, and stricter guidelines for closing of accounts for such things as overdrafts. It is best to have your whole program neatly packaged before you offer any part of it to your membership. Finally, you must have your credit union attorney review and approve these policies and procedures.

Youth Savings

Are your current children's savings accounts growing at a steady pace with regular deposits? As these young savers grow older, are they using other credit union services? Many very young children are encouraged to start saving their money. In fact, many parents start a savings account for a newborn, and both they and the child continually add to the account through the years. Many children have allowances or earn money, which they deposit regularly into savings accounts, usually, at their parents' financial institutions.

You must establish an age at which a young member may have a savings account without joint ownership by an adult and an age at which the youth may withdraw funds without a co-signer. Some financial institutions set this age at 12 or 13. Others vary age limitations based on the member's character, academic achievement, and overall ability of handling the account.

Whatever policies and procedures you establish for your youth savings program, be careful not to encourage minimum deposits that do not grow—accounts that can become costly over time. Some credit unions shy away from promoting children's savings accounts because they believe that a minimum deposit can sit for years with no activity. This situation is easily remedied through education and

Figure 1
Young members evolving financial requirements

motivation of both parents and children.

Some credit unions tie a savings program to their youth loan program, wherein the youth must deposit a set amount into a savings account regularly with each loan payment. With a good incentive program and parents' involvement, you can ensure that young members continually add to their savings.

Spending Services

When young people go shopping, they find alternatives to cash as useful as their parents do. Be sure to include share drafts, ATM cards, and check (debit) cards in your youth program. Make account age limitations and other restrictions flexible enough to consider a younger youth who has better character and better income than an older youth. You may decide to require a co-signer for these share draft accounts, ATM cards, or check cards.

Loans

Young members need loans for a variety of reasons. For example, a youth with a paper route, lawn mowing business, job at a fast food restaurant, or even a regular baby sitting job may need to borrow money to purchase a new bicycle, a new lawn mower, or an educational trip. A youngster with a 4-H project idea may need a loan to get started. Perhaps a youth has a candy-making business at home and needs a loan to purchase candy molds and supplies.

A loan from your credit union becomes a learning experience for young members, while at the same time earning interest for the credit union, building member loyalty for future services, and strengthening the community.

Few credit unions have youth lending programs—only some 2,000 to date. However, those that do make youth loans report success. For example, Aaron Carbone, director of marketing at Hartford (Conn.) Healthcare Credit Union, enthusiastically states that the "Say Yes to Youth" program, designed by the Connecticut Credit Union League, is very successful.

"A big part of the future for credit unions is to establish a relationship with youth today because within the next 10 to 20 years, they will constitute our major membership base," Carbone says. Hartford Healthcare CU offers a savers club for young members from birth to age 12 and the "Say Yes to Youth" program for members ages 13 to 19.

Your youth loan program should include loans to members under your state's age of majority. Establish criteria for these youth loans, such as age, maximum loan amounts, co-signer requirement, interest rate, repayment terms, purpose of loan, and so on.

Will you charge the same interest rate on a loan to a young member as you charge your adult members? Will your repayment terms be the same? Will you assess any fees or reduce fees on these youth accounts? Will you require a co-signer for some or all youth loans? See Figure 2 for sample youth loan limits.

Money & Credit Guides

The following publications can help you plan and build your youth program:

"Teach Children About Money," a brochure for parents, with recommendations for allowances and ideas for motivating children to save (CUNA; stock no. 20807S; $14 per 100 with quantity discounts; available by calling 800-356-8010)

"Youth Loan Manual," a guide to youth loan policies and procedures and compliance and legal issues (the Family Involvement Council of the Michigan Credit Union League; item #2156; $38.95; available from CUorp Images & Ink by calling 800-262-8285).

Risk

In 20 years of offering a youth program, Ottawa County School Employees Credit Union in Grand Haven, Mich., has had no losses on youth loans. This credit union makes youth loans starting at age 12 when a child may borrow $300 without a co-signer. "Give a youth a loan, and it will be indelibly imbedded in his mind. You show confidence in him, and he will remember who gave him his first loan," explains Fred McNew, vice president of lending. "A youth loan is not high risk, and it pays such great dividends."

McNew further states that youth loans build toward future relationships. He is very positive about the program and comments on a 15-year-old who is now repaying his third loan and of another youth who eventually took out his mortgage with the credit union. "Our program is definitely a success," McNew says.

Figure 2
Sample youth loan limits

Years of age	Maximum loan	Interest rate	Repayment term	Co-signer?
10 to 11	$100	2pts. less than regular rate	1 year	Yes
12 to 13	$200	2pts. Less	1 year	Yes
14 to 15	$300	2pts. Less	1 year	Yes
16 to 17	$500	1pt. Less	18 months	No
18	$1000 More for a new or used vehicle	1pt. Less	2 years	No

As a rule, young members assume the new responsibility and pay off their loans in a timely manner. With an adult co-signer, credit unions have a better chance of collecting the balance owed, but no guarantee. Usually, a well-written letter to the parent or co-signer ensures repayment. Proper screening and education of both children and parents help curtail any loan losses.

Of course, some risk is simply a part of doing business. When your credit union began offering debit cards or even credit cards, you implemented controls to minimize risk, and factored in the costs of fraud and charge-offs. Consider this same risk planning when you design your youth program. If a minor refuses to repay a loan, you cannot legally collect the debt, and you cannot ensure that the co-signer will pay. However, credit unions with youth loan programs report that, in practice, risk from youth lending is minimal.

There is no better way to motivate young members to learn about wise money management than by providing them with a full range of financial services.

Getting Started

When your credit union decides to design and implement a youth program, where do you start? How do you begin? Start with credit union co-workers, especially those who have children. Survey your members. Find out their children's saving and spending habits and specific financial needs.

Check with other credit unions, your local and state credit union leagues, and other financial institutions to learn what they are doing with youth programs. You'll find a great deal of interest but very little going on, especially in the area of youth lending. But don't let the dearth of youth lending models dissuade you. Even though you might wish you had more guidance from existing youth loan programs, you can manage the risk of experimentation with sound, flexible policies.

There is no better way to motivate young members to learn about wise money management than by providing them with a full range of financial services. And by establishing your credit union now as the best source of all your young members' current and future financial services, you'll ensure a thriving membership in the future.

Bonnie Miller is the former director of marketing for the $1.6-billion-asset Suncoast Schools Federal Credit Union in Tampa, Fla. You can e-mail her at bonnie@sunstar.com.net.

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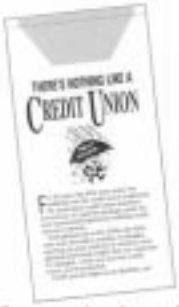

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Cats, Dogs, or Kangaroos?

by John Uchida

Youth savings clubs are an easy and effective way to reach younger members. They're also popular with kids, parents, grandparents, and even employees! Whatever your credit union's asset size or field of membership, you can have a successful youth savings club. All you need is a few hours a month, minimal financial and staff resources, and some enthusiasm.

Why Create A Youth Club?

In addition to being fun, youth savings clubs offer the following benefits: membership growth within the current common bond; stronger primary member relationships; increased secondary account balances; community recognition; and enhanced staff morale.

Impressively, many credit unions report that once they implement a youth savings club it has more than doubled, and often tripled their youth accounts. Credit unions offering youth savings clubs have a higher percentage of young members (more than 9% of their membership) than those that don't (less than 6%).

Serving the children of primary members fosters adult member loyalty and establishes the credit union as the primary financial institution for the entire family. In most cases, adult members use three or more credit union services when their children are enrolled in a youth savings club, compared to the average member, who uses two. Promoting savings accounts for children also provides a steady flow of deposits over time.

Finally, offering a youth savings club can help increase employee morale. Staff often enjoy helping educate young people, and they may enthusiastically contribute to club activities. Many credit unions report that employees and volunteers have *as much fun* with youth savings clubs as the club members themselves.

The number of staff hours required to operate a club depends on the type of club you select, your membership, and the frequency of club activities. Most credit unions require one to three staff members to work directly with the club, spending only one to ten hours per month.

Youth accounts are typically less expensive to maintain than adult accounts because they are characteristically low-withdrawal, high-deposit accounts. The share accounts of members under the age of 18 are usually quite stable with an average balance of at least $500. Club expenses can range from as little as $100 to as much as $10,000 a year or more, depending on the level of participation. Credit unions report that club ex-

penses typically decrease once the club is operating for more than a year.

Selecting a Turnkey Club

There are two ways to start a youth savings club—develop your own, or purchase one from a national program. "Turnkey" clubs have animal character names and club mascots that create an identifiable image that appeals to young savers. Cats, dogs, kangaroos, and rabbits are popular mascots. Because parents typically make the enrollment decisions, whichever club you select should appeal to both the children and the parents. Clubs that are attractive, educational, fun, and well organized will meet this requirement.

Credit unions that purchase clubs find national programs to be affordable, economical, easy to implement, administer, and promote. Most national programs will provide training, ready to use promotional materials, club merchandise, operational manuals, marketing plans, and direct mail assistance. (See "CU Youth Materials," p. 23A for a list of clubs.)

Before you decide on the type of club that will work best for your credit union, do some long-term planning. Make sure your mascot and/or club's image is one that will positively represent your credit union in the long run—often a decade or more. Compare programs, materials and resources carefully before selecting a youth savings club:

- Contact your league to determine if they endorse a national program and/or have one of their own.
- Contact each program and request a promotional package, and a reference list of current program users you can call for an evaluation.
- Compare start-up costs and annual fees, if any.
- Compare the quality and quantity of each program's materials and marketing plan.
- Consider how well the club's mascot and materials meet your desired image.
- Contact references to check the level and quality of services offered. Ask about training, on-going support, and new material development.
- Review club agreements. Is the club sold to other financial institutions in your area? Are there restrictions on the use of club materials and promotional plans?

Creating Your Own Club

Credit unions that develop their own clubs may desire a program designed specifically for their membership. Some may also want complete control over the program's activities and promotions. Some tie their club's identity to the characteristics of their membership or sponsor. You may also want to consider starting and operating a club with other credit unions in your area. Cooperation provides great community visibility for the club, and reduces material, activity, and promotional expenses.

Make your club goals specific and realistic. Put them in writing, and make them definite and measurable. To effectively evaluate the club at the end of the year, state the goals in terms of amounts, dollars, and percentages within a specific period. For example:

- To increase membership by youth from birth to age 13 by (percentage) by (date).
- To increase the number of youth share accounts by (number) by (date).
- To increase youth share balances by (dollars) by (date).

Youth savings clubs may have varying account and service policies. To help define yours, answer the following questions in writing before you launch the club:

- What ages will the club serve?
- Will the club members be required to pay a membership fee, or will it be waived?
- What is the minimum number of members required to start?
- Are dividends rates lower,

Offering Savings Incentives

There are several ways to offer incentives (prizes). Most clubs announce them in a flyer, newsletter or postcard inviting members to make a deposit to receive a free gift. Some clubs operate on a point system crediting members for deposits, good grades, or participation in club activities. Others give tokens for deposits and members can cash in points or tokens for gifts. Regardless of what you decide, be sure to keep members informed.

This article was adapted from the booklet "Youth Savings Clubs: A Great Way to Reach Your Youth Market." For a free copy, send a self-addressed, stamped ($0.78) 9x12-inch envelope to "Youth Club," CUNA Publications, P.O. Box 431, Madison, WI 53701-0431.

Mascots of the Safari Youth Club, which has helped more than 3,100 members aged 12 and under amass $968,000 in savings in five years at State Employees Credit Union in Lansing, Mich.

higher, or the same as other share accounts?

• What is the minimum share account balance required for earning a dividend?

• Is there a minimum share account balance to remain a member in good standing?

• Is there a fee for account withdrawals after a certain number?

• What are the incentive levels/requirements for earning prizes?

• Will parents be able to deposit money through payroll deduction, and will that count toward any savings incentive (see sidebar)?

You will want to establish a twelve-month club action plan, a marketing plan, and a budget. In its simplest form, your marketing plan can be a month-by-month event calendar. For example, you may want to schedule a spring Easter egg hunt, a summer reading program, a fall savings seminar, and a "giving tree" during the holiday season. Reviewing the plan and applying dollar figures to each event or activity forms the basis of your annual budget. Set club accounts up under a specified subaccount number or heading to simplify record keeping.

Get Everyone Involved

Whenever possible, encourage employees to enroll their own children in your savings club. That way they can help promote the program. If you need additional assistance, recruit volunteers from your membership, especially retired members. And, don't forget your board of directors: they may enjoy getting involved. Continuously share the information you've gathered with your board and staff. Request their input and support. The more involved they are in planning, the more they will be willing to contribute to the club's success. •

John Uchida is vice chair of the National Youth Involvement Board (NYIB) and CEO of Space Age Federal CU, Aurora Colo. You can call him at 800-666-6828, ext. 127.

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"FREE MONEY ON CAMPUS"

by Alex Hultgren

College students are constantly flooded with information. But seeing the above phrase on a flyer is certainly an attention-grabber, isn't it? For student-run credit unions and branches, this sort of creative approach is an unusually effective way to stand out from the competition and educate potential members about credit unions' low-fee advantages.

College student credit unions have been around for more than 20 years, and many have operated with a purely volunteer staff since their inception. For example, Georgetown University Alumni & Student Federal Credit Union (GUASFCU) is run by more than 200 student volunteers who have helped build the institution to more than $5.5 million in assets.

"I've been involved with [GUASFCU] all four years at Georgetown and it has been an incredible experience," says Georgetown senior Bradford Caldwell, the credit union's VP of external relations. "Having started as a teller and worked my way up, my credit union training has completely complemented my classroom instruction."

This hands-on experience for students who get involved constitutes the main difference between student-run credit unions and credit unions that simply serve students. Any credit union can offer members great financial products and services. A student-run credit union takes things a step further by providing students with internships and/or employment opportunities—to the benefit of both the students and the institution.

Many Models

There are as many different types of student-run credit unions and branches as there are campuses. Each credit union has developed a model that works best for its school and its students' demographics. Most credit unions with student-run branches have some combination of employees and volunteer student interns working in an on-campus branch. An example is the Credit Union for Berkeley Students (CUBS), a branch of Cooperative Center FCU, serving the students at the University of California at Berkeley. The branch is run by a paid general manager, a paid teller, and 30 student volunteer interns.

Although institutions such as CUBS can provide a wider selection of products and services than their stand-alone counterparts, the students involved tend not to have as much responsibility—and opportunity to learn—as those in credit unions run solely by students.

"While the students running stand-alone credit unions get experience in accounting and retain complete control of the operation," says Ritesh Somani, CUBS president, "our interns get thorough training in marketing, HR, and member service. Neither model is really better than the other – they're just different."

Similarly diverse in their structures, many of the stand-alone student-run credit unions have grown to the point of hiring full-time managers and other employees. Other credit unions have remained volunteer-run and are proud to remain that way. Some offer a wide array of products and services such as ATM and credit cards, while others only offer shares and loans. But each of these institutions can say proudly that they are student-run from the ground up.

This unorthodox management structure presents one of the biggest challenges facing these unique institutions, the problem of management continuity. Imagine if your credit union or branch had a guaranteed complete staff turnover — from member service reps to the CEO — every four years! The student-run credit unions that have prospered have done an outstanding job of building strong internal training programs to ease these inevitable transitions.

Unique Advantages

The advantages of student-run credit unions and branches are numerous. For example, students produce high quality work at little or no cost to the institution. Of course, students will not work as tellers for free when they can get paid for the same job down the street at the local bank. But by giving students experiences and responsibilities they'll not find elsewhere, credit unions get excellent results from volunteers.

Working with students gives credit unions constant and relevant feedback on the effectiveness of its marketing efforts. The credit union that distributed the "free money" flyer cited above, for example, knew that students on that campus rarely read the paper. They did, however, respond to handouts — and the total cost of distributing flyers that way was negligible. If the credit union did not have direct contact with the students, they might have spent thousands of dollars on ineffective ads.

Another key advantage of having students involved with your credit union is in the area of university relations. A student-run credit union or branch can register as an official student organization, giving access to incredible perks, ranging from free on-campus office space to free mailing lists of incoming students.

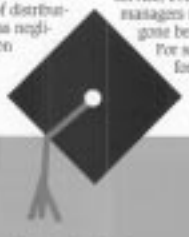
These credit unions also can make a big difference in educating their members by working with the new-student orientation program to educate incoming students on financial responsibility. This helps the credit union educate not only their members, but also their potential members. And it provides a great service that university administrators love.

As with most small credit unions, student credit unions face the challenge of incorporating new technologies with very limited resources. This is especially true given the nature of college students, who tend to be technologically savvy and demand a wide variety of convenient ways to access their accounts. A number of credit unions have been able to overcome these demands by planning well in advance to bring on a new service, even though the current managers realize they will be long gone before the service arrives.

For some, the solution is to form partnerships with larger area credit unions to offer the more-expensive and complex services.

Serving college students is a great way to tap into the elusive 18-to-24-year-old market. It represents a strong investment in the future of your credit union. But to serve students most effectively, get them involved on the inside! ●

Alex Hodgson is executive director of the Campus Credit Union Council (CCUC), a trade association that supports and represents credit unions serving college students. You can reach him at ccu@aol.com or 202-218-7741.



Note to HR Managers:

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The Birds and the Bucks:
Bringing the Facts of Finance into the Classroom

by Heather Harris

Imagine that you just received a call from a 5th-grade teacher asking you to do a classroom presentation on money management. How would you feel? Scared? Anxious?

You don't have to be. Some of the most effective teachers are those who are willing to share their personal experiences and knowledge. This includes credit union employees and volunteers because you see the personal money management extremes on a daily basis, and can provide important insights to students. When you teach basic financial skills with a dose of reality, you can change a student's life.

Your Potential

The National Youth Involvement Board (NYIB) is a volunteer national network of credit union professionals who help credit unions attract, serve, and educate young members. The NYIB tracks its volunteers' classroom presentations annually. It reports that during the past school year, more than 5,300 credit union speakers visited classrooms across the nation. As a result, more than 110,000 students heard messages on the wise use of credit, savings options, budgeting, smart shopping, careers, and credit union philosophy.

For more than one-half of the presenters, it was their *first time* back to a classroom since they were students. Invariably the CEOs, tellers, loan officers, and branch managers who went back to school found the experience "extremely positive," "rewarding," "enlightening," and "great fun!"

Making classroom presentations offers personal benefits, too. You can hone your public speaking skills, enhance your creativity, and expand your consumer financial knowledge. Facing a classroom of lively seventh-graders can quickly improve your listening skills, teamwork and cooperation techniques, and sense of humor.

In addition to educating future credit union members about the benefits of promptly repaying loans, student presentations help your credit union support the International Credit Union Operating Principles. A single 55-minute visit to a high school can address the principles of ongoing education, social responsibility, and financial stability. As financial cooperatives, credit unions should make the effort because it's the right thing to do — as well as being smart marketing.

National Youth Involvement Board volunteer Diana Wheeler, youth coordinator for GFA Federal Credit Union (Gardner, Mass.), shows teaching materials she uses with third graders. Classroom presentations are a full-time job for Wheeler, who averages about five a day all year.

According to Dana Dugway, executive director of the Jumpstart Coalition for Personal Financial Literacy, "only about 20% of students learn about personal finance in school." Jumpstart, a group of more than 70 organizations (including CUNA), is working to encourage states to make knowledge of personal finance part of high school graduation standards.

Jumpstart's recent national survey to determine the literacy level of high school students revealed dismal results. "The average score was 57%, which is an 'F'," says Dugway. "The survey showed that young people lack adequate knowledge in personal finance," Dugway added. (See "Our Vulnerable Youth," p. 4A.)

Although it's important that young people learn how to manage their money, only 14 states mandate consumer economics in school curricula. Therefore, parents remain the primary teachers. Unfortunately, many parents are not good role models. Without good financial management skills, poor money

habits pass from generation to generation. Credit union professionals like you can help break the cycle.

Getting Ready

If you're invited into a classroom, the following suggestions can help you educate students with style and confidence. Because the teacher will play a major role in the success of your presentation, get answers to the following questions right away:

- What grade(s) will you be speaking to?
- What are the students currently studying?
- How large is the class?
- Will classes be combined for your presentation?
- How long is the class period?
- How many students will attend?
- Do the students have special needs?

Before entering the classroom, prepare yourself. Know your subject and be comfortable with the material you plan to cover. Also know your audience. Think about what interests the group. Try not to cover too much material and strive to make the information relevant and useful for the grade level. And know yourself. If you are uncomfortable telling a joke, don't. Do what is comfortable and natural for your presentation style.

Making a Good Impression

While no two presentations are alike, there are some general rules for success. First, keep it simple—concentrate on one or two specific subjects. Start strong. An attention-grabbing introduction goes a long way in getting your point across. A dramatic statement such as "Did you know that on average you'll earn more than $1 million dollars in your lifetime?" can start you off with a bang.

Keep in mind that students have short attention spans and are bombarded with information all day long. If you want to be heard, don't lecture. Variety is essential, so change your teaching technique every 20 minutes. Try role playing, hands-on activities, and simulations. For example, if you are discussing credit, have a student pose as a loan officer and another as an applicant. Use examples and short stories to stress a point. Students learn in different ways, so make your presentation interesting to all types of students.

When you teach basic financial skills with a dose of reality, you can change a student's life.

If possible, arrive early and observe the students you'll be addressing. Start on time and project energy! Don't talk down to students, and don't use jargon. Silence is golden when asking questions—give them time to formulate a response. Use eye contact and establish a relaxed and informal atmosphere by moving around the room. Cover the topic thoroughly and appropriately for the age group, and end with a flourish. Sum up what you've been emphasizing, and close with handouts or gifts.

Afterwards, take a few minutes to review your presentation and make notes for the next opportunity. What went well? What needs improving? Send a thank-you note to the teacher and/or the school. And finally, get the credit you deserve by submitting a classroom presentation report card to the NYIB. Contact your league or the NYIB for a supply of cards and reporting guidelines.

With a bit of enthusiasm, a general knowledge of the subject, and a handful of credit union pens, your classroom presentation is guaranteed to be a hit. Just remember: You are the expert. With less than 70% of high school graduates entering the workplace as "literate consumers," today is the time to get started and make a difference in a student's life! ♦

Heather Harris is chair of the National Youth Involvement Board (NYIB) and AVP of consumer education, State Employees Credit Union, Lansing, Mich. You can reach her at hharris@sccu.org or 517-267-7264.

A Lansing, Mich. summer school class tours the consumer financial library at State Employees Credit Union. Members borrow more than 200 books, videos, and magazines from the credit union's library each month.

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National Youth Involvement Board
Heather Harris, Chair
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Lansing, MI 48933-2320
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PO Box 1277
Arvada, CO 80001
Phone: 303-427-4222

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Michigan Credit Union League
PO Box 5049
Southfield, MI 48086
Phone: 248-352-1250

Teaching Resources & Lesson Plans

American Council on Consumer Interests
Web: http://hiker.ps.missouri.edu/DHI/ACCI/

Center for Economic Education University of Florida
Web: http://www.coe.ufl.edu/CEE/Materials.html#teen

Consumer Information Center
Pueblo, CO 81009
Email: catalog.pueblo@gsa.gov
Web: http://www.pueblo.gsa.gov/

Consumer World
Web: http://www.consumerworld.org/

Federal Reserve Bank of Chicago
Web: http://www.frbchi.org/consumer/consumer.html

Federal Reserve Bank of Minneapolis
Web: http://woodrow.mpls.frb.fed.us/econed/index.html

Federal Trade Commission
Web: http://www.ftc.gov/ftc/consumer.htm

Jumpstart Coalition for Personal Financial Literacy
919 18th Street, N.W., Suite 300, Washington, DC 20006
Phone: 888-45-EDUCATE
Fax: 202-223-0321
Email: info@jumpstartcoalition.org
Web: http://www.jumpstartcoalition.org/

National Endowment for Financial Education
4695 South Monaco St., Denver, CO 80237-3403
Web: http://www.nefe.org

National Council on Economic Education
1140 Avenue of the Americas, New York, NY 10036
Email: evolard@ncglobal.org
Web: http://www.economicsamerica.org/

National Institute for Consumer Education
559 Gary Owen Building, 300 W. Michigan Ave., Eastern Michigan University, Ypsilanti, MI 48197
Web: http://www.nice.emich.edu/nicelesson.html

University of Nebraska at Omaha Department of Economics
Web: http://econweb.unomaha.edu/econweek/lessons.htm

University of Missouri-St. Louis Center for Economic Education
Web: http://econweb.unomaha.edu/st-louis.htm

U.S. Bureau of Engraving and Printing
Web: http://www.bep.treas.gov/opteng.cfm?id=12

U.S Consumer Gateway
Web: http://www.consumer.gov/

U.S. Department of Education
Web: http://www.ed.gov/pubs/parents.html

Other Web Sites of Interest

Central Pacific Bank
Web: http://www.cpbi.com/fun.html

In Charge
Web: http://www.aba.com/aba/cool/showme_rel.html?location=/PR_091688incharge

Investing for Kids
Web: http://hyperion.advanced.org/3096/

National Teach Children to Save Day
Web: http://www2.mmshelkcenter.org/mba/kidsave.htm.

Save for America
Web: http://www.schoolsavings.com/program

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CUNA & Affiliates

Mr. NUSS. Thank you, Mr. Chairman. Through various new initiatives, CUNA is developing an even more aggressive strategy to promote consumer financial education.

Because we are a nonprofit, cooperative financial institution, losses to the credit union have a direct impact on the entire membership due to a potential increase to loan rates or a decrease in interest on savings.

Credit unions believe that reaffirmations are a benefit both to the credit union and to the member who by reaffirming with the credit union continues to have access to financial services and to reasonably priced credit. We are also aware of concerns with cases of abusive creditor practices, but the current Bankruptcy Code caught the violators and the size of the penalties imposed will act as a deterrent to others. The ability of credit unions to enter into reaffirmation agreements with their members is so important that if reaffirmations were severely limited or made not usable, CUNA would strongly oppose bankruptcy reform legislation regardless of what the rest of the bill might contain.

Reaffirmations can be vital to credit union members. We recently had a case where a young couple with three children accumulated too much debt. We attempted to work out a debt consolidation loan for that family, but all creditors were not willing to cooperate. The young mother was working part-time, going to school to obtain a degree to try to increase her earnings. Unfortunately, a medical problem arose last year which pushed the limits of the family budget and they filed a chapter 7. This couple did not want to cause a loss to their credit union because we had worked closely with them to respond to their financial crisis and, more importantly, they wanted to preserve the needed access to financial services and reasonable credit. So they did reaffirm with the credit union.

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 H. R. 833.

My full written statement contains the credit union's bankruptcy statistics and in looking over some of the cases we have experienced over the past few years, I honestly believe there are cases in there where the debtor could have paid at least part of that debt under a chapter 13 filing.

In conclusion, let me say that I am very pleased you are holding this hearing today. The 105th Congress strongly supported needs-based bankruptcy and this hearing today shows that the 106th Congress is continuing to move toward passage of bankruptcy reform legislation. We encourage Congress to push for passage of such bills before Congress' fall recess.

Thank you.

[The prepared statement of Mr. Nuss follows:]

PREPARED STATEMENT OF LARRY NUSS, CEO, CEDAR FALLS COMMUNITY CREDIT UNION, CEDAR FALLS, IA, REPRESENTING THE CREDIT UNION NATIONAL ASSOCIATION, INC.

Good afternoon, Chairman Grassley and Chairman Gekas, and members of the Senate and House Judiciary Subcommittees. I am Larry Nuss, CEO of Cedar Falls Community Credit Union in Cedar Falls, Iowa, and I very much appreciate the opportunity to be here to tell you about our concerns with the increasing number of bankruptcies and how this is impacting credit unions. I particularly want to tell you what affect it is having on my credit union. I am speaking on behalf of the Credit Union National Association (CUNA), which represents over 11,000 state and federal credit unions nationwide. We are very pleased that this joint hearing is being held today on the important issue of consumer bankruptcy reform and that we have this forum to lend our support of meaningful bankruptcy reform legislation.

Cedar Falls Community is a $33 million state-chartered, federally insured credit union. We were first chartered in 1958 as an employee-based credit union. Due to expansion and mergers, the credit union now has a community charter and currently serves 8,300 members who reside in or work for a business located in the Iowa countries of Bremer and Black Hawk and the employees of Beatrice Cheese in Fredericksburg, Iowa. Family members are also eligible for membership.

We invest in our members who clearly use the credit that we offer. Currently, we have over $25.5 million in loans to our members: $13.1 million in auto loans; $1.2 million in mortgages; $5.5 million in home equity loans; $1.5 million in other real estate loans; $1.3 million in other secured loans; $1 million in unsecured loans; and $2.2 million in credit card accounts.

We do offer credit cards to students, but the line-of-credit is dependent on the member's monthly gross income. In some cases we require the credit card to be secured by deposits in the credit union or be co-signed by the parent. We recently approved a $2,000 line of credit for a student when the parent agreed to co-sign because the student applicant only qualified for a $500 line of credit. The reason we did this was the student wanted our credit card so he could pay off an existing credit card with a much higher interest rate.

Nationwide bankruptcy filings exceeded 1.4 million in 1998, which was a 2.7 percent increase from the 1997 filings. In fact, bankruptcy filings have set records in 1996, 1997, and 1998. And it is not anticipated that there will be a decrease to these high numbers for 1999. Consumer bankruptcy filings made up 96.9 percent of those 1998 filings. Credit unions are quite concerned about this steady increase in bankruptcy filings nationwide in the last few years because they have seen a similar increase in the number of credit union members who file. Preliminary data from credit union call reports to the National Credit Union Administration show that credit unions had approximately 253,000 filings in 1998, which is an increase to the 250,000 filings in 1997. The 1997 figures were an increase of 20% over 1996 levels, and the 1996 filings were 35% higher than the 1995 figures. CUNA estimates that almost half of all credit union losses in 1998 were bankruptcy-related and that those losses reached $684 million. In Iowa, bankruptcy filings by credit union members remained near all-time highs in 1998 at 2,169 filings. In each of the last three years Iowa credit unions reported bankruptcies per thousand members of 2.6 or higher.

Similar to the national figures, but on smaller scale, Cedar Falls Community has seen a significant increase in chapter 7 bankruptcy filings, which cause the greatest loss to the credit union. In 1995 we had 17 chapter 7 filings; the number increased to 21 in 1996, to 24 in 1997, but dropped somewhat to 18 in 1998. On the other hand, we have very few chapter 13 filings; zero in 1995; 4 in 1996; 2 in 1997; and 1 in 1998, that converted to a chapter 7. Our losses due to bankruptcy have also increased—from almost $20,000 in 1995, doubling to just over $40,000 in 1997, and then dropping off some in 1998 to almost $35,000.

As a cooperative not-for-profit credit union, a loss due to bankruptcy impacts the entire membership. Therefore, we are proactive in combating the number of bankruptcies with our careful lending policies. We require a written application for all loans, including credit card applications. Prior to making a decision to extend the credit, we review the member's credit report and carefully determine that the applicant has the ability to repay before extending credit. We verify income and see that a reasonable debt-to-income ratio would not be exceeded by a credit extension. We routinely monitor our credit cards, and we do not increase the credit limit unless a member specifically makes the request for an increase, and we do so only after a review of the member's current debt and ability to repay.

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% 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. At Cedar Falls Community we refer those members who are experiencing financial difficulties to the local CCCS and have found that beneficial for the members and their families. A credit union staffer is beginning her second year as director of that local CCCS. In addition, we try to counsel our members when they are confronted with credit problems. Our loan officers are encouraged to work with members who are experiencing payment problems. We have 55 members who have established separate saving accounts which the credit union can access to pay designated creditors on a periodic basis. We encourage our members to contact their other creditors to negotiate reduced payments and and/or payoffs so the credit union can provide a consolidation loan and /or automatic repayment for the member. When we receive a credit application and discover the member has outstanding collections or judgments, we work with those members. We may suggest that they agree to a six-month payment plan to demonstrate an effort to satisfy those obligations. Or, we may suggest they consider a monthly deposit in an account at the credit union which can be used to pay off those obligations. Subsequently, we will review their credit request. Because of our belief that financial education is so important, we even reach out to our community schools—our credit union staff conducts classroom courses in credit at the local junior and senior high schools.

However, even with financial counseling, we certainly recognize that there are some instances in which bankruptcy may be the only alternative for members, the way for them to get the needed "fresh start."

Credit unions want to help their members avoid financial difficulty through learning to manage their credit. We believe that more emphasis should be placed on consumer financial education so people can learn how to manage credit and what the alternatives to bankruptcy are. The CUNA Bankruptcy Subcommittee recently reported that "[e]ducation was found as one of the most promising strategies to consider in attempting to reverse the trends in bankruptcy." Credit unions have found that educating their members about credit and how to use it can be an effective deterrent to filing for bankruptcy.

Therefore, CUNA strongly supports the provision in H.R. 833, the House bankruptcy reform legislation, that requires the debtor to receive credit counseling prior to filing for bankruptcy and prohibits the chapter 7 or 13 debtor from receiving a discharge if the debtor does not complete a course in personal financial responsibility. Recognizing that consumers need to know more about alternatives to bankruptcy so they can make a more informed decision, we also support the provision in the bill that requires a consumer debtor to be given a notice about bankruptcy and a description of services from trustee-approved credit counseling services. Any sensible bankruptcy reform should include education provisions to give debtors the tools they need to make wise decisions about filing for bankruptcy and to succeed financially after bankruptcy.

In addition, credit unions recognize that financial education needs to be made available early on and before consumers experience financial problems. Therefore, we support the sense of Congress that each of the states should develop curriculum on personal finance for elementary and secondary schools. Credit unions are currently going into their local schools and teaching students about money management. In addition, the National Youth Involvement Board (NYIB), a national network of credit union volunteer professionals, helps credit unions to educate young members. During the 1997–1998 school year more than 5,000 credit union speakers visited classrooms across the country, and as a result, more than 110,000 students heard about the wise use of credit, savings options, budgeting, and careers.

Many credit unions also devote office space for consumer libraries that enable members to use a wide range of financial periodicials, manuals, and books to learn more about money management and to research buying decisions, retirement plans, and a host of other issues relating to personal finance. And, through various new initiatives, CUNA is developing an even more aggressive strategy to promote consumer financial education.

CREDIT UNIONS SUPPORT REAFFIRMATIONS AS A BENEFIT BOTH TO THE MEMBER AND TO THE CREDIT UNION

Because we are a not-for-profit cooperative financial institution, 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. Therefore, we have 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. Our credit union members take this policy seriously and continue to reaffirm on their credit union loans.

Credit unions believe that reaffirmations are a benefit both to the credit union, which does not suffer a loss, and to the member, who by reaffirming with the credit union continues to have access to financial services and to reasonably priced credit. We are aware of concerns of abusive creditor practices, recently highlighted in high profile press coverage, but note that the current Bankruptcy Code, in fact, caught the violators. The size of the penalties imposed will undoubtedly act as a deterrent to others. The ability of credit unions to enter into reaffirmation agreements with their members is so important that if reaffirmations were severely limited or made not usable, CUNA would strongly oppose bankruptcy reform legislation regardless of what the rest of the bill might contain.

As I said, reaffirmations are very important to credit unions, and they can be vital to the credit union member. For example, a young couple, members of our credit union and parents of three children, had accumulated too much credit card debt. We first attempted to work out a debt consolidation loan for them, but not all the creditors were willing to cooperate. While working part-time, the mother went back to school to get a degree that would increase her earnings. Unfortunately, a medical problem pushed the limits of the family budget, and they filed a chapter 7. This couple did not want to cause a loss to their credit union, recognizing we had worked closely with them to try to respond to their financial crisis, and more importantly, they wanted to preserve the needed access to financial services and reasonable credit.

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 H.R. 833. This provision was a compromise developed out of the bankruptcy reform bills that received overwhelming support in the 105th Congress.

Earlier, I cited my credit union bankruptcy statistics from the last four years. Out of 86 bankruptcies, only 6 were in chapter 13. And, looking over these I believe there are cases in which the member who filed a chapter 7 would have been able to pay back some of the debts in a chapter 13. For example, just last summer our attorney during examination at the 341 hearing got evasive answers from a debtor about the schedules he filed and the information he had provided on his financial statement to the credit union. It seemed pretty clear from our records that the debtor did have an ability to repay some of his debts. However, our lawyer advised us that the cost to pursue the issue would be more than we could recover, and so we did not do it. With its random audit requirement needs-based bankruptcy should ensure that debtors provide accurate schedules and documentation of income and thus, those who can repay some part of their debts would be required to do so.

Again, let me say that I am pleased you are holding this hearing today. The 105th Congress strongly supported needs-based bankruptcy, and this hearing today shows that the 106th Congress is continuing to move toward passage of bankruptcy reform legislation. We encourage Congress to push for passage of such bills before Congress' fall recess.

Again, let me say I appreciate the opportunity to testify today before this committee and would be happy to answer any questions.

FACT SHEET
CEDAR FALLS COMMUNITY CREDIT UNION
CEDAR FALLS, IOWA

Total assets: $33 million
Number of members: 8,300
Total loans: $25.5 million

Total charge-offs due to bankruptcy:

1998: $34,813
1997: $40,237
1996: $39,353
1995: $19,848

Number of filings:	*Chapter 7*	*Chapter 13*	*Total*
1998:	18	1 (converted to 7)	18
1997:	24	2	26
1996:	21	4	25
1995:	17	0	17

Mr. GEKAS. We thank the gentleman, and we turn to Mr. Klein for the customary 5 minutes.

STATEMENT OF GARY KLEIN, ESQUIRE, SENIOR ATTORNEY, NATIONAL CONSUMER LAW CENTER, BOSTON, MA

Mr. KLEIN. Mr. Chairman and distinguished members of the joint committee. Good afternoon, my name is Gary Klein. I'm a senior attorney with the National Consumer Law Center. Throughout my career, I have represented working families, the elderly, and other consumers with severe financial problems who have little alternative other than to turn to the bankruptcy system. It is the experiences of these families that has spurred me to work for balanced and fair bankruptcy legislation.

Although the views I express to you today are mine, in the last several years, I have been joined by a wide range of organizations, including those representing consumers, women and children, working families, labor, the civil rights community, older Americans, and the guardians of the system, bankruptcy judges. These groups oppose, as do I, the kind of one-sided, radical, and unbalanced bankruptcy overhaul that was contained in last year's conference report and which has been re-introduced this year as H.R. 833.

Earlier, H. R. 833 was represented to be a pro-consumer bill. I am here today as a consumer advocate to tell you that it is not so. I have a simple message. Last year's failed conference report should not serve as your starting point in developing legislation this year. You have a real opportunity in the spirit of bipartisanship and respect for the historical balance that has guided past bankruptcy legislation to move expeditiously and fairly to pass a bankruptcy reform bill.

This lesson was driven home in the closing weeks of the 105th Congress when the Senate passed bipartisan legislation, 97 to 1, that required accountability from both debtors and creditors for conduct that contributes to bankruptcy. Though I don't agree with each and every provision in that bill, I commend its bipartisan and balanced approach.

Unfortunately, the Senate approach was rejected in the closing hours of the 105th Congress. And not surprisingly that rejection, as embodied by the conference report, failed to be enacted into law.

But there was a lesson to be learned from that experience. It was that legislation cannot be predicated on the myths that had permeated the debate during the first year and a half of the 105th Congress, and which have been repeated here today. I would like to examine a few of those myths.

Myth No. 1 is that everyone can repay their debts because the economy is booming. The reality is that there have been extraordinary structural changes to the economy that have left millions of American families struggling.

First, it often takes two wage-earners to make a middle-income family's budget work. With an increase in divorces, single-parent households, and with the skyrocketing cost of childcare, many women are unable to manage their debts and to provide necessities for their children. For the first time this decade we see more women in the bankruptcy system than men.

Second, we have millions of American families with no health insurance. An unforeseen medical emergency increasingly leads to bankruptcy for those families.

Third, we have rising education costs. The average student loan debt burden for students leaving college increased from $8,200 to $18,800 between 1991 and 1997.

Fourth, we have downsizing in many industries, and breadwinners are going back to work at lower-paying jobs with fewer benefits. We see those folks in the bankruptcy system as well, when they can't pay the debts they took before they were downsized out of their jobs.

And, finally, piled on top of all of these changes, we have a massive increase in household debt for credit cards and home mortgages. In 1975, total household debt was 24 percent of aggregate household income. Today total household debt is a staggering 104 percent of aggregate income.

Much of the recent increase in consumer debt is fueled by an explosion in credit card marketing. More than 3 billion credit card solicitations were sent out 1997 and again in 1998. As the Consumer Federation of America has pointed out, every American family was offered more than $1 million of credit in each of those years.

Credit solicitations and other forms of marketing are designed to encourage consumers to rely on credit. Much of the marketing is done to people who once would have been considered unacceptably high risk. Due to high interest rates of 16, 18, 20 percent or higher, the lending community has discovered that it profits when families get in over their heads. Those families cannot pay their credit card balance in full each month, and they pay a lot of interest, but they also are vulnerable even to small life problems, which can put them over the edge.

Myth No. 2, there is widespread abuse of the bankruptcy system by debtors. The reality is that a recent study published by the American Bankruptcy Institute found that less than 3 percent of debtors had used the bankruptcy system to avoid debts they could afford to repay. That is just 3 percent. Industry-funded studies purporting to show otherwise, and which show that only 15 percent can afford to pay, have been discredited by the General Accounting Office for lack of empirical rigor.

Myth No. 3, it is the lax bankruptcy system which causes credit losses that are passed onto consumers in the form of higher interest rates. The number $400 was thrown around earlier in this hearing, and for the first time I heard a figure of $550 in extra interest costs associated with bankruptcy losses for each American family.

The reality is that the lending community is scapegoating the bankruptcy system for losses associated with bad loans. If the bankruptcy system were totally eliminated tomorrow, the vast majority of debts which would have been discharged in bankruptcy

would be written off by lenders anyway because the families involved simply can't afford to pay. Even the creditors' own studies acknowledge that. The only impact of bankruptcy is that it gives debtors a legally-enforceable fresh start, the same second chance which has been guaranteed since biblical times.

To a large extent, Mr. Chairman, the bankruptcy problem is nothing but a bad loan problem. Industry analysts estimate that 50 percent of bankruptcy losses could be eliminated if the industry instituted minimal underwriting guidelines. The lending community has chosen not to take this step because their current practices are quite profitable. However, as a consequence, the banking community must accept that it is reaching some borrowers who won't be able to pay.

Mr. Chairman, never has 5 minutes seemed so short. I was wondering if I could have the indulgence of an additional minute or two to finish my statement.

Mr. GEKAS. You may proceed, without objection.

Mr. KLEIN. Thank you very much.

When we get to the fundamental truth here, after stripping away these myths, the reality is that in crafting balanced reform, the worst problems you need to confront are those of families losing their homes, facing wage garnishment, repossessions, and the hopelessness of crushing debt.

I want to close with both an observation and an appeal. The observation is that in the last 5 years, as the American economy has roared and the stock market has soared, the number of people seeking assistance from consumer credit counseling has increased faster than the number of bankruptcies. More than 2 million people sought and obtained credit counseling in 1998 alone, and these included college students, single mothers, farmers, and the elderly. When you add that to the 1.4 million people who filed for bankruptcy, it should be clear that there are millions of Americans, millions of your honest constituents, people who are not deadbeats, who have run into real trouble with credit and keeping their families afloat. They do need to be accountable to their creditors to the extent possible, but bankruptcy, their only safety valve, should not be remade into an expensive and unworkable system designed to keep families yoked to debts they have no hope of ever repaying.

The flip side of individual responsibility is corporate responsibility. I agree with Mr. Nuss; there needs to be credit education about the potential negative side of reliance on credit. To start that process, it is essential that credit card applications and credit card statements have prominent, plain English disclosures that truly tell consumers the real terms and consequences, as well as the real risks, associated with credit.

[The prepared statement of Mr. Klein follows:]

PREPARED STATEMENT OF GARY KLEIN, ESQUIRE, SENIOR ATTORNEY, NATIONAL CONSUMER LAW CENTER, BOSTON, MA

INTRODUCTION

Mr. Chairmen and members of the Joint Committee, on behalf of our low-income clients, the National Consumer Law Center[1] thanks you for inviting us to testify today regarding consumer bankruptcies and their impact on the banking system.

There is a great deal of misinformation circulating about the increase in bankruptcy filings and purported abuses in the system. The reality is that more debtors use the bankruptcy system because more debtors are having serious financial problems. American families increasingly face foreclosure, repossession, utility shut-off, wage garnishment and extensive collection activity on unsecured credit card debt. In short, more American families are using the bankruptcy system, because more American families are having trouble paying their debts.

My testimony will focus on four questions:

- Why more filings?
- Does the lending industry share responsibility for consumer financial hardship and the increase in bankruptcy filings?
- Are substantial costs of bankruptcy passed on to non-bankrupt consumers?
- Are the amendments captured last year in the Conference Report (H.R. 3150) and reintroduced this year as H.R. 833 fair and balanced?

I. WHAT HAS CAUSED THE INCREASE IN FILINGS?

The fact that more bankruptcies are being filed is not evidence, in itself, that debtors are abusing the system. The reality is that more cases are filed, because more American families are faced with crushing debt. There is much more consumer credit outstanding than ever before. With the additional extension of credit, comes additional risk. (See the Case Study in the Appendix for a typical example of an American family forced to file bankruptcy because of the convergence of consumer debt, job loss and divorce.)

The increase in bankruptcy filings is an unfortunate consequence of several significant structural changes in the American economy. These changes have combined to create a rise not only in bankruptcy, but also in foreclosures,[2] repossessions, utility disconnections[3], credit card defaults[4] and visits to consumer credit counseling agencies.[5] Nevertheless banks continue to record profits, fueled in large part by credit card income.[6]

These are the factors which have contributed to the increase in filings:

- *Downsizing, economic dislocation, income disruptions, and underemployment.* Families are increasingly impacted by instability in employment income, par-

[1] The National Consumer Law Center is a nonprofit organization specializing in consumer credit issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys around the country, representing low-income and elderly individuals who request our assistance with the analysis of credit transactions. The National Consumer Law Center also serves as an advocate for low-income consumers on consumer lending and bankruptcy. NCLC publishes materials for lawyers and consumers, including the nationally acclaimed book *Surviving Debt: A Guide for Consumers.* NCLC has trained lawyers and counselors nationwide on consumer protection issues relevant to low-income consumers.

My experience includes 14 years as an attorney representing clients in bankruptcy, as an advocate for consumers on bankruptcy issues, as a teacher and trainer of other lawyers, and as an author of books on bankruptcy and consumer debt. My work also focuses on helping homeowners with financial problems avoid foreclosure. The bankruptcy system has always provided an important means to that end.

[2] Foreclosures have more than tripled since 1980. There were approximately half a million foreclosures in 1998.

[3] *See* National Consumer Law Center, "The Energy Affordabilty Crisis of Older Americans" p. 23 (August, 1995).

[4] Ausubel, "Credit Card Defaults, Credit Card Profits and Bankruptcy", 71 Am. Bankr. L.J. 250 (1997); See Consumer Federation of America, "Recent Trends in Credit Card Marketing and Indebtedness" (Report issued July, 1998) at p. 1.

[5] The number of consumers who have visited consumer credit counseling for help in the last 20 years has increased at a faster rate than bankruptcy filings. More than two million families sought such help in 1998.

[6] Commercial banks earned 14.8 billion in the third quarter of 1997, the third consecutive quarter of record profits and the 19th consecutive quarter involving profits of more than 10 billion. *See* Ausubel, Credit Card Defaults, Credit Card Profits and Bankruptcy, 71 Am. Bankr. L.J. 250 (1997) for a discussion of the role of credit card profits in the current boom in banking.

ticularly at the lower end of the wage spectrum.[7] Although unemployment remains low, many workers file bankruptcy after being forced to shift to lower paying jobs. A surprising statistic, based on data compiled by Visa and MasterCard, is that no more than 29% of bankruptcies are caused by overspending. The balance of filings are caused by other life events over which consumers have little or no control.[8]

- *Rising debt to income ratios*. More families have more debt. Part of the reason for this is that the lending community has aggressively marketed credit card debt,[9] because it profits from the very high interest rates. Another factor is the unprecedented increase in the cost of education and the corresponding increase in student loan debt.[10] One family in six below $25,000 in annual income, spends more than 40% of its income on debt service.[11]
- *Reliance on two wage earners to make ends meet.* This change in a fundamental condition of the economy means that every family has double the risk. With two wage earners vulnerable to income instability, any change for either one creates enormous pressure on the family budget. Child-bearing and time off to raise children mean that a family which was getting by on two incomes is forced to rely on only one.
- *Rising divorce rates.* A corollary of the latter factor is that when a family splits up, the pressure of running a household with less total income is impossible. Bankruptcy debtors are disproportionately single parents.[12]
- *Uninsured medical debt.* At a time when a two day stay in the hospital to deliver a baby can cost as much as $20,000, the uninsured have virtually no options to manage medical debts.[13] Bankruptcy has played an increasing role as the only way out.[14]
- *Aggressive Creditor Collection Action.* Wage garnishments, debt collection by aggressive telephone calling, and pursuit of legal remedies push many families into bankruptcy.[15] Few debtors can afford to pay an attorney to defend against a debt collection or wage garnishment action even when they have valid legal defenses.[16] Many bankruptcy filers report that their attempts at non-bankruptcy payment arrangements were rebuffed.
- *Deregulation.* As rates and terms of credit have been deregulated, an increasing number of American families have gotten credit on bad terms.[17] High rate

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[7] Even MasterCard recognizes this trend. In its recent report on debt and bankruptcy, its economist states: "Stagnation in real wages during the last 20 years and the growing disparity in income and wealth, . . . have almost certainly contributed to the rise in personal bankruptcies. Declines in income caused by job loss make it more difficult for those affected to service previously accumulated debt." Chimerine, "Americans in Debt: The Reality", p.24 (MasterCard International 1997).

[8] Id. at p. 25. And even the 29% figure is acknowledged to overstate spending problems as a contributing cause of bankruptcy. Id.

[9] More than three billion credit card solicitations were sent out in 1997 and 1998. Consumer Federation of America, "Recent Trends in Credit Card Marketing and Indebtedness" (Report issued July, 1998) at Table 2 (citing industry sources). *See* Hays, "Banks Marketing Blitz Yields Rash of Defaults" Wall Street Journal, p. B1 (September 25, 1996). MBNA, one of the largest issuers, claims 30 million credit card solicitations each month in 1997 together with 6 million phone solicitations. Hansell, "A Banking Powerhouse of Cards", N.Y. Times, p. C1 (October 22, 1997).

[10] *See* Chacon, "Debt Burden Soaring for U.S. Students" Boston Globe, p. 1 (October 23, 1997). According to the Nellie Mae study on which the article is based, an average student's debt increased from $8,200 in 1991 to $18,800 in 1997.

[11] "Family Finances in the United States: Recent Evidence from the Survey of Consumer Finances" Federal Reserve Bulletin, p. 1, 21 at Table 14 (January, 1997). Overall, the rate is one family in nine.

[12] *See* Sullivan, Warren, and Westbrook, As We Forgive Our Debtors, pp. 147–165 (Oxford University Press, 1989).

[13] *See* Hildebrandt and Thomas, "The Rising Cost of Medical Care and Its Effect on Inflation", Federal Reserve Bank of Kansas City, Econ. Rev. p. 47 (Sept./Oct. 1991).

[14] Domowitz & Sartrain, Determinants of the Consumer Bankruptcy Decision, p. 25 (1997).

[15] *See* Dugas, "Special Report: Going Broke, Wage Garnishments a Key Factor" USA Today, p. 1A (June 10, 1997); Hansell, "We Like You. We Care About You. Now Pay Up. Debt Collecting Gets a Perky Face and Longer Arms", NY Times, F.1 (Jan. 26, 1997).

[16] Forrester, "Constructing a New Theoretical Framework for Home Improvement Financing," 75 Ore. L.Rev. 1095 (Winter 1996); Sterling & Shrag, "Default Judgments Against Consumers: Has the System Failed?" 67 Denv. U. L. R. 357, 384 (1990).

[17] *See, e.g,* Adding Insult to Injury: Credit on the Fringe, Hearing before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, 103rd Cong., 1st Sess. (1993). Rehm, In a First, FDIC Warns Banks About Dangers of Sub-Prime Lending, 162 Am. Banker 2 (May 13, 1997).

home equity loans, credit card interest rates exceeding 18%, and consumer fraud tied to credit are frequent contributing causes of bankruptcy.[18] As some borrowers are increasingly pushed into "sub-prime" loans at high rates, the bankruptcy system is at the fulcrum of a "chicken and egg" problem. Are high risks justifying high rates, or are the high rates causing defaults which generate risk?[19]

- *More Credit Means More Bankruptcy.* The clearest correlation of bankruptcy cause and effect is between the increase in the amount of credit outstanding and the number of filings. The number of bankruptcies and the total amount of consumer debt in our society have moved upward together in lockstep.[20] It is not surprising that as more Americans borrow more money, more families have financial troubles.

II. DOES THE LENDING INDUSTRY SHARE RESPONSIBILITY FOR CONSUMER FINANCIAL HARDSHIP AND THE INCREASE IN BANKRUPTCY FILINGS?

The reasons for the increase in bankruptcy filings are complex. Although banks and other lenders are correct in pointing out that they are not entirely to blame, it is disingenuous of them to assert that they should not bear some responsibility, at least to the extent of their own conduct.

Credit solicitations and other forms of marketing are designed to encourage consumers to rely on credit. Much of the marketing is done to people who once would have been considered unacceptably high risk. Due to high interest rates, the lending community has discovered that it profits when people get in over their heads so that they cannot pay their balance in full each month.[21] This generates remarkable profits for banks. However, it also makes consumers vulnerable even to small life problems which can put them over the edge.

Every American family has a budget which represents a fixed pie. The 55 to 60 million households that carry a credit card balance from month-to-month have an average balance of $7,000 and pay more than $1,000 per year in interest and fees.[22] And, of course, the families that wind up in bankruptcy are almost always on the high side of average in their debt-load and the low side of average in income.[23]

Are consumers at fault for using the credit which is marketed to them? Of course not. Millions of American families are not irresponsible. They are simply using the credit offered to them for the purposes for which it is offered. Families don't go out and borrow $7,000 on a credit card all at once. They make small purchases over a period of time, and make the minimum payments which the lender requests. Few consumers understand that making only the minimum payments means that their balance will grow and payments will take an ever larger piece out of their monthly budget (at 18% interest or higher) for debt service.[24]

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[18] *See* Forrester, "Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing" 69 Tul. L. Rev. 373 (1994).

[19] Home mortgage loans with high loan-to-value ratios, particularly so-called 125% loans, are the major component of the recent surge in home equity lending, both in the prime and subprime markets. Recent growth in the volume of 125% loans has been unprecedented: 1995—$1 billion; 1996—$4 billion; 1997—$10 billion; 1998—an estimated $20 billion. Although such loans are at least partially secured by the debtors' homes and can result in the loss of the home, they carry interest rates much closer to those of credit cards, in the 13–15% range. See "A 125% Solution to Card Debt Stirs Worry," Wall Street Journal, Nov. 17, 1997

[20] Three neutral academic studies show this remarkable correlation. Ausubel, Credit Card Defaults, Credit Card Profits and Bankruptcy, 71 Am. Bankr. L.J. 250 (1997); Bhandari & Weiss, The Increasing Bankruptcy Filing Rate: An Historical Analysis, 67 Am. Bankr. L.J. 1 (1993); Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, before the Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, United States Courts, (April 11, 1997). These studies stand is sharp contrast to credit industry funded studies which purport to show otherwise.

[21] Borrowers who maintain balances pay interest at rates which typically range from 14.5 to 19.8%.

[22] See Consumer Federation of America, "Recent Trends in Credit Card Marketing and Indebtedness" (Report issued July, 1998) at p. 1.

[23] Research shows that the median after-tax income of debtors is under $20,000 annually. Id. $1,000 in annual debt service expenses can thus be a very meaningful proportion of a debtor's income.

[24] Industry analysts estimate that, using a typical minimum monthly payment rate on a credit card, it would take 34 years to pay off a $2,500 loan, and total payments would exceed 300% of the original principal. George M. Salem and Aaron C. Clark, GKM Banking Industry Report, Bank Credit Cards: Loan Loss Risks are Growing, p. 25 (June 11, 1996). Credit card statements, unlike mortgage loans and car loans, do not disclose the amortization rates or the total interest that will be paid if the cardholder makes only the minimum monthly payment *See* 11 U.S.C. § 1637. A provision which would require new Truth in Lending disclosures on these issues was included in the bill passed by the Senate (§ 209), but deleted from the Conference Report.

Congress should not enact legislation which undermines effective bankruptcy relief for struggling families. Some reform is necessary, but that reform should be balanced and should help consumers avoid the credit problems which contribute to bankruptcy.

We do not advocate that creditors make less credit available to low and moderate income consumers, but rather that consumers have the tools and information they need to use credit wisely. Appropriate consumer protections designed to reinforce the lending community's obligation to employ responsible credit practices include:

- enhanced disclosure to consumers about the consequences of making minimum payments,[25]
- enhanced disclosures concerning teaser rates of interest,[26]
- protections against unilateral interest rate increases which are unrelated to a change in the lender's cost of funds,[27]
- prohibition of unilateral credit limit increases,[28]
- prohibition of security interests based in credit card agreements,[29]
- protection against so called "cashed check loans,"[30]
- prohibition of credit card cash advance machines in casinos,[31]
- prohibition against making credit cards available to persons such as students who have no present ability to make more than nominal payments,[32] and
- reregulation of interest rates.[33]

If lenders choose to resist legislation to address these problems for consumers, they ought not be heard to complain about the bankruptcies which are the inevitable result. Industry consultants estimate that credit card companies could cut

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[25] Minimum payments on many credit cards will not amortize the loan, thus sucking people in over their heads. If minimum payment terms are offered which won't amortize the debt in two years, consumers should be told, in clear and conspicuous language, what they need to pay, if they make no further charges, in order to pay off the loan over a two year period.

[26] Low initial rates are designed to encourage consumers to use credit in the first months after credit is granted. Many consumers do not understand what the permanent rate will be or the impact of the rate change on a large unpaid balance.

[27] Some lenders raise rates arbitrarily after consumer balances reach a certain level. Interest rate changes should be tied to an actual change in the interest rate environment so that consumers are not caught unawares. See, Hershey, "Sales of Credit Card Accounts Are Hurting Many Consumers," NY Times, March 2, 1999, p.A1 (documenting the effect of unilateral interest rate changes."

[28] When a lender extends a consumer's credit limit unilaterally, in some cases after a consumer is already struggling with the existing balance, the message is that the lender believes that the consumer can afford to take on more credit. Consumers would not be hurt by having to ask for more credit, rather than having it offered unilaterally. Such a request should trigger at least minimal underwriting requirements.

[29] These hidden security interests in items of property which have no resale value to the creditor provide inappropriate leverage to lenders in the collection process even though there is no potential that the lender could make money in the event of repossession.

[30] Consumers receive checks from several major lenders in the mail for as much as $5,000. Not everyone understands that cashing these checks can lead to acceptance of high rate credit terms. In addition, providing preapproved credit through cashed checks eliminates the cooling off period which more common credit application processes provide.

[31] With credit card cash advance machines prevalent in casinos, is it surprising that some gamblers get overextended on credit and file bankruptcy based on those credit card debts?

[32] Offering credit aggressively to college students who cannot afford to pay off their debts until they join the work force some years later is prevalent because interest mounts until the debt is paid. By lending aggressively to college students, at a time in life when money is scarce, our society runs the risk of saddling people early in life with an unmanageable problem which will later preclude more important uses of credit such as purchase of a home and car. See US PIRG, "The Campus Credit Card Trap: Results of a PIRG Survey of College Student" (September 1998).

[33] Competition in the market has not worked to keep rates at reasonable levels. On a procedural level, the Supreme Court has held that credit card lenders can rely on the law in the state where they are incorporated in setting the interest rate and many of the other terms of credit for consumers nationwide. This has led to a "race to the bottom". States deregulate in order to create the best possible environment to encourage a credit card company to locate there in order to export terms of credit across the country. This helps certain states create jobs. However, it means that those other states that do want to regulate for the benefit of their citizens can no longer do so. Either states should be freed to create and enforce meaningful regulations or the federal government should step in with consumer protections.

their bankruptcy losses by more than 50% if they would institute minimal credit screening.[34]

III. ARE SUBSTANTIAL COSTS OF BANKRUPTCY PASSED ON TO NON-BANKRUPT CONSUMERS?

A. Is the system failing to recapture money which debtors can afford to pay?

Nobody likes to be owed a debt which is not paid back. Yet our society has a system of debt forgiveness which has roots in the Bible.[35] Forgiveness and a fresh start have always been a part of that system.[36]

A family's ability to repay its debts is limited by its income. Data shows that Americans in bankruptcy are far poorer than their non-bankrupt counterparts. The median after-tax income of a family in chapter 7 bankruptcy is under $20,000, or approximately half the national median.[37]

The credit industry has focused substantial resources on attempting to show that despite this relative poverty, there are many families who are obtaining a bankruptcy fresh start even though they can afford to pay. Based on this assumption, they would set up a system in which some debtors are forced into payment plans.

However, if such plans are not entered voluntarily by the debtor, they have little chance of success, absent extensive and impracticable coercive mechanisms. For this reason, forced participation in payment plans has consistently been rejected by Congress and the two most recent government-sponsored commissions which have studied bankruptcy.[38]

Apart from this procedural difficulty, there is no empirical evidence which shows that debtors can afford to pay. In 1989, Professors Sullivan, Warren and Westbrook published the results of an evaluation of a substantial statistical database and concluded:

> The overwhelming majority of Chapter 7 debtors—90% by any measure—could not pay their debts in Chapter 13 and maintain even the barest standard of living. . . . A new bankruptcy regime that invested more time to find and to investigate the potential can-pay debtors would prompt only a small amount of new repayment. This is the classic case in which a policy maker asks if the game is worth the candle.[39]

The creditor industry's own study released last year,[40] purporting to show the opposite, has been severely criticized by the General Accounting Office.[41] Once the credit industry study's results are adjusted to take account of the GAO critique, it shows that only about 5% of debts could be repaid by debtors—*if they undergo five*

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

[35] Deuteronomy 15:1–2 ("At the end of every seven years thou shalt make a release. And this is the manner of the release: every creditor shall release that which he has lent unto his neighbor and his brother, because the Lord's release hath been proclaimed".)

[36] *Local Loan Co.* v. *Hunt*, 292 U.S. 234, 244 (1934). *See* Gross, Failure and Forgiveness, ch. 6 (Yale University Press 1997).

[37] Consumer Federation of America, "Recent Trends in Credit Card Marketing and Indebtedness" (Report issued July, 1998) at p. 1; Warren, "The Bankruptcy Crisis" 73 Ind. L. J. 1081, 1102–1103 (Fall 1998); Sullivan, Warren and Westbrook, "Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991", 68 Am Bankr. L. J. p. 121, 128 (1994).

[38] *See* Report of the Commission on the Bankruptcy Laws of the United States, Part I at 159 (1973); H.R. Rep. No. 595, 95th Cong., 1st. Sess. 120–121 (1977); Report of the National Bankruptcy Review Commission, Vol. 1, at pp. 89–91 (October 20, 1997).

[39] Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, As We Forgive Our Debtors, pp. 205–206 (Oxford University Press, 1989). This seminal book and the empirical work which underlies it remains the single most authoritative published source for studying bankruptcy demographics. It has been updated more recently in an article by the same authors which concludes that debtors are now even poorer and less able to pay their debts than they were when the initial study was done. "Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–1991", 68 Am Bankr. L. J. 121 (1994).

[40] Barron and Staten, "Personal Bankruptcy: A Report on Petitioners' Ability to Pay", Monograph 33, Georgetown U. Credit Research Center (1997). This report is reprinted as Appendix G–2.b to the National Bankruptcy Review Commission Report.

[41] GAO Report, Personal Bankruptcy, The Credit Research Center Report on Debtors' Ability to Pay, GAO/GGD–98–47, p. 6 (Feb, 9, 1998) The GAO concluded that the study's "fundamental assumptions were not validated". In addition, *the GAO review concluded that the credit industry's study: failed to assess the accuracy of the data collected; failed to account for major expenses which bankruptcy debtors have after filing including payments on non-housing secured debt and reaffirmed or non-discharged non-priority debts; failed to evaluate potential differences among the sites chosen for the study; and failed to use statistically valid research techniques.*

year repayment plans.[42] This means that the creditor's own study ultimately shows that bankruptcy debtors can afford to pay about a penny on the dollar per year. *That result was supported recently by a study funded by the American Bankruptcy Institute showing that only 3% of chapter 7 debtors can afford to pay back their debts in a hypothetical chapter 13 plan.*[43]

Outside bankruptcy, no reasonable creditor would spend more than a penny to collect a penny. Proposals to require five year payment plans for many more debtors have a heavy price tag, including costs of administration and monitoring, costs to resolve disputes about capacity to repay, and costs of collecting and distributing payments.

Either the taxpayer would have to fund these costs, or if they are debtor funded, they will reduce the receipts available to creditors in a repayment plan. If taxpayer funded, every American would be helping banks and other creditors collect their one cent per dollar per year. If debtor funded, the one cent per dollar per year repayment capacity of debtors is even further reduced.

Finally, requiring five year repayment plans would have enormous social and human costs. People use the bankruptcy system for many legitimate reasons. If navigating the system is made more difficult, and if a meaningful fresh start is denied when some cases inevitably fail,[44] more debtors would be left with the burden of unmanageable debts.[45] Loss of homes, repossessions, wage garnishments, utility shut-off and family stress associated with unmanageable debts would be the inevitable result. While these social and human costs of denying chapter 7 relief to debtors may be difficult to quantify, they nevertheless remain an important part of the relevant equation.

B. Are losses associated with bankruptcy being passed on to other better off consumers in the form of higher interest rates?

The banking industry has claimed that it is losing 40 billion dollars each year to the bankruptcy system and that it is passing those costs on to consumers at the rate of $400 per family.[46] *These numbers are ridiculous.* Families may be discharging debt in bankruptcy, but the creditor's own study, discussed above, shows that these are not debts which consumers can afford to pay.

In reality, the lending community is scapegoating the bankruptcy system for losses associated with bad loans. The vast majority of debts which are discharged in bankruptcy would have been written off if no bankruptcy had intervened. The only impact of bankruptcy is that it gives debtors a legally enforceable fresh start—the same second chance which has been guaranteed since Biblical times.

Equally important, there is no evidence that lenders would reduce rates on unsecured consumer lending if they could avoid bankruptcy losses. Between 1980 and 1992, the federal funds rate at which banks borrow fell from 13.4% to 3.5%. Nevertheless, credit card interest rates actually rose.[47] How likely is it that other types of savings, if any could be realized, would be passed on to consumers rather than investors?

To a large extent, the bankruptcy "problem" is nothing but a "bad loan" problem. It could be fixed if lenders were more closely attentive to underwriting. For the most part, the lending community has chosen not to take this step. The present interest rate environment has taught lenders that substantial profits can be made from extending credit to risky borrowers, such as college students. However, in exchange, the banking community must accept that it is reaching some borrowers who cannot afford to pay.

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[42] Warren, "The Bankruptcy Crisis" 73 Ind. L. J. 1081 (Fall 1998); Klein, "Means Tested Bankruptcy: What Would it Mean?" 28 U. Mem. L. Rev. 711 (Spring, 1998).

[43] Culhane and White, "Means Testing for Chapter 7 Debtors: Repayment Capacity Untapped?" (American Bankruptcy Institute, 1998).

[44] 67% of repayment plan cases fail under current law. There is every reason to think that if economically marginal debtors are forced into involuntary repayment plans, the failure rate would be higher.

[45] *See* D. Caplovitz, Consumers In Trouble: A Story of Debtors in Default pp. 280–285 (Free Press, 1974).

[46] The unpublished credit industry-funded report which served as the basis for this claim has also been criticized by the GAO for lack of analytical rigor. GAO/GGD–98–116R "The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan.

[47] Medoff and Harless, The Indebted Society, at pp. 12–13 (Little, Brown & Co. 1996).

IV. ARE THE AMENDMENTS CAPTURED LAST YEAR IN THE CONFERENCE REPORT (H.R. 3150) AND REINTRODUCED THIS YEAR AS H.R. 833 FAIR AND BALANCED?

The bankruptcy system established in 1978 has been remarkably efficient. It provides critical relief to financially troubled American families at a low cost to taxpayers. Over the years, many open issues under the bankruptcy law have been resolved by court decisions and carefully crafted Congressional amendments.

To the extent the increase in the number of bankruptcies suggests that there are problems in the consumer lending system, responsibility for fixing those problems must be shared between consumers and lenders. Congressional reform, if any, should be balanced and narrowly targeted at abuses by both debtors and creditors.

It would be a mistake to enact reforms without addressing reckless lender conduct which pushes people into bankruptcy. Offering additional credit, for example, to families already struggling to pay their debts hurts not only borrowers, but also the borrowers' honest creditors if the new credit pushes the family over the edge. Similarly, failure by one creditor to seriously consider payment arrangements outside bankruptcy for families facing hardship may lead to a bankruptcy filing which affects all creditors.

To the extent there has been a focus on debtor misconduct, the burden of proof remains on the credit industry. To date it has not been met. Simply saying that more people are using the system, is not proof that people are misusing the system.

Some observers ignore the fact that the present system already has a variety of protections which are designed to effectively root out abuses by debtors. These include: Rule 9011,[48] objections to discharge,[49] complaints to determine dischargeability,[50] good faith requirements,[51] Rule 2004 examinations,[52] creditors' meetings,[53] dismissals for substantial abuse,[54] and criminal sanctions.[55] Indeed, it is unclear why the creditor community does not believe that the small number of cases where significant repayment appears possible are not resolvable under the "substantial abuse" test of 11 U.S.C. § 707(b).[56] Perhaps additional tightening of this provision would make it work better.

An additional set of balanced reforms may be appropriate as long as they do no harm to the majority of honest debtors who urgently need help. Provisions should be narrowly targeted to address debtors who truly are abusing the system without affecting lower income debtors who would be hurt by having to litigate additional issues. Creditors should not be allowed to obtain leverage by forcing new litigation on consumers who cannot afford to pay the costs of defending.

Appropriate reforms should also create incentives for debtors to use a repayment plan option in bankruptcy in order to repay their debts. Significant actions could be taken to make the costs of those plans more manageable and to enhance outcomes for debtors who complete plans.[57] Provisions in H.R. 833 which limit stripdown related to automobiles and personal property and which require debtors in chapter 13 to litigate many new dischargeability issues will undermine chapter 13 rather than reinforce it.

Finally, the system should penalize dishonest creditors. These include creditors whose actions push people into bankruptcy and those who take advantage of debtors after they file by coercing inappropriate reaffirmation agreements.

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[48] Fed. R. Bankr. P. 9011.

[49] *See* 11 U.S.C. § 727.

[50] *See* 11 U.S.C. § 523(a).

[51] *See, e.g.*, In re Barrett, 964 F.2d 588 (6th Cir. 1992) (finding that debtor's second chapter 13 filing, when he had insufficient income to support plan, was in bad faith but that third chapter 13 case, after circumstances had changed was not in bad faith); In re Love, 957 F.2d 1350 (7th Cir. 1992).

[52] Fed. R. Bankr. P. 2004. It is hard to see why creditors concerned about abuses can't utilize the examination process to uncover them. If it is not financially feasible for a creditor to pursue an examination, why should taxpayers instead bear that burden for the creditor's benefit.

[53] 11 U.S.C. § 341. Fed. R. Bankr. P. 2003.

[54] 11 U.S.C. § 707(b).

[55] 18 U.S.C. §§ 151–157. Bankruptcy fraud is punishable by fine and imprisonment for up to five years. 18 U.S.C. § 157.

[56] That is the provision which Congress *added* to the Code in 1984 and which has functioned to root out debtors who can afford to pay their creditors. *See, e.g.*, In re Kelly, 841 B.R. 908 (9th Cir. 1988); In re Krohn, 886 F.3rd 123 (6th Cir. 1989) (substantial abuse found where debtors could pay back their debts with "good, old fashioned belt tightening").

[57] For example, efforts should be made to provide improved credit reporting for people who complete chapter 13 payment plans. In addition, the discharge available in chapter 13 should be as broad as possible in order to serve as incentive to choose that chapter. Costs can be lowered by encouraging secured lenders to accept modifications to their mortgages in exchange for more favorable treatment.

Honest and careful creditors should always be paid before abusive debt collectors, lenders that encourage gambling in casinos, predatory second mortgage lenders, and lenders who are unreasonable in refusing to accept non-bankruptcy payment plans. Lenders whose actions violate the bankruptcy laws should be subjected to meaningful and straightforward penalties.

CONCLUSION

The lending community should not be allowed to scapegoat the bankruptcy system for lending decisions which result in bad debt. The right to participate in the bankruptcy system should require honesty not just on the part of debtors, but also by creditors. No legislative action should ignore the significant hardships of the millions of American families who are overwhelmed by debt.

APPENDIX

Case Study

Mrs. M is a 39-year old mother of three children, two of whom are living at home. Her financial problems started in 1994 when her husband lost his job in construction. Since that time, he has been underemployed; his earnings have declined from an average of $52,000 annually between 1990 and 1993 to an average of $26,000 between 1994 and 1997. Starting in 1994, the family's primary income has been $30,000 which Mrs. M earns as an administrative assistant at an insurance company. Mr. and Mrs. M have struggled successfully to maintain payments on a home they bought in 1987 since their financial problems began in 1994.

Mr. and Mrs. M have also had significant credit card bills since the late 1980's. Despite their financial problems, they avoided default on those debts by making minimum payments between 1994 and 1997. However, the total amount of their credit card debts increased from about $11,000 in 1994 to about $29,000 in 1997, largely due to the accumulation of interest at an average annual rate of 17.5%.

In 1997, Mrs. M's financial problems worsened, because Mr. M moved out of the family home. An additional strain was created because Mrs. M attempted to provide financial help to her oldest daughter who began her first year of college. In family counseling, Mr. and Mrs. M acknowledged that their marriage was breaking up largely because of the constant pressure of financial problems and Mr. M's continuing inability to find steady work.

Mrs. M attempted to make payment arrangements with her credit card lenders so that she could focus on her mortgage obligation. She was told that no payment arrangements were possible and that she should "borrow money to pay off the debts." Mrs. M went to consumer credit counseling where she was advised that her budget did not support any payments on credit cards. She was advised to consider chapter 7 bankruptcy in order to eliminate the credit card debts so that she could maintain her payments on the mortgage.

In September 1997, Mrs. M obtained advice from a bankruptcy lawyer and reluctantly filed bankruptcy. She will discharge approximately $35,000 in unsecured debts. She will reaffirm and continue to make payments on her mortgage and car loan—totaling $1,320 monthly.

Mr. GEKAS. We thank the gentleman.

The Chair now yields to itself the 5 minutes allotted to each member for posing questions.

Mr. Klein, you acknowledged in the last portion of your statement that there, indeed, are people who are in the bankruptcy system who can repay some of their debt. We have fought strenuously to make sure that those who cannot repay will automatically have a chapter 7 fresh start. If they can repay, and you acknowledge that there are some, even only 10 out of the 270 million people in our country, shouldn't they be made accountable to repay or to be shown that they don't belong in bankruptcy?

Mr. KLEIN. At some point, Mr. Chairman, you have to craft the tool to the particular need in the system. If it is a small number of people, as the American Bankruptcy Institute study showed, what we need is a very narrowly-targeted tool, a scalpel, to address the problem, something that can be administered fairly and evenly.

The problem with the tool in H.R. 833 is that it is complicated; it tries to put everyone into a cookie cutter; it imposes unworkable spending limits on families——

Mr. GEKAS. With respect to your opinion, we suggest that it is not complicated, that we have parameters that determine who is poor and unable to repay, who is under the median income level that starts triggering the application of remedies. I respectfully submit to you that you can't assert, as you did before the American Bankruptcy Institute panel discussion that was televised last year that, of course, there are some people in bankruptcy who can repay, and then you pooh-poohed it as meaningless. That is a bit offensive to those of us who are trying to say that those who can repay some of their debt ought to be put in a mechanism whereby they can do so. That is all there is to that.

Mr. Nuss——

Mr. KLEIN. I'm sorry, go ahead.

Mr. GEKAS. I have limited time.

Mr. Nuss, you and Judge Kenner are sitting propitiously next to each other with different views on reaffirmation—not different views, but you need to talk to each other after this panel on how you can accommodate each other.

I, too, have always felt that reaffirmation is a good tool for people who in certain circumstances must utilize it. The Sears decision, Judge Kenner—we can do this back and forth, Mr. Nuss and Judge Kenner—that wouldn't, shouldn't prevent what Mr. Nuss is agreeing should be done with credit card customers who need reaffirmation, should it?

Ms. KENNER. I agree with that—I am not saying, I am not suggesting that we should do away with reaffirmation agreements. I think they can be a good thing.

Mr. GEKAS. Yes.

Ms. KENNER. I suspect that Mr. Nuss and I would disagree as to whether a debtor should ever be permitted to reaffirm an unsecured debt, a totally unsecured debt, in order to maintain or obtain a new line of credit post-bankruptcy. Because I think that what that might very well do is put the debtor back in the same untenable, debt-ridden position that he or she was in before bankruptcy.

But I think reaffirmation agreements are absolutely appropriate in some instances, but, as the bankruptcy judge, I think I should take a look at all of them.

Mr. GEKAS. I want you to know—and this will be my last comment—I wanted to ask Mr. Sheaffer and Mr. Hammonds a question, but I want to restrict my own time, so that I can restrict everybody else's time. [Laughter.]

This individual, the chairman, is vastly interested in straightening out the problems of reaffirmation, and we want to do the right thing. I want you to know that. So I will be consulting regularly with everyone who wants to on that subject.

The gentleman from New York is allotted 5 minutes.

Mr. NADLER. Thank you.

Mr. Hammonds, you state in your testimony that only 1 percent of all credit card accounts end up in bankruptcy, and then 96 percent of all accounts are paid as agreed. Now we have received testimony in the past that, thanks in large measure to the deregulation

of interest rates and the decline in the cost of funds, the spread earned by credit card operations were three to five times more profitable than are other banking operations in the 1983-to-1993 period. In fact, MBNA's total return on shares from its initial public offering in January 1991 through last quarter equaled 1,800 percent compared to the total return of the S&P 500 of just 284 percent, or about five times or six times more profitable.

In fact, the cost of funds now stands at about 5.5 percent while the average credit card interest rate, not including all those new penalties my constituents keep complaining about, is not 5.5, but 15.7 percent. So my question to you is, how much of that profit spread goes to cover the cost of that minuscule 1 percent of losses due to bankruptcy in your industry, and how much goes to your shareholders?

Further, since deregulation and low interest rates have seemed to benefit your industry more than consumers, why should we expect any tightening of the bankruptcy rules to be passed along to consumers? You state in your testimony that bankruptcy costs consumers $400 a year. Since you are obviously pocketing the profits you earn on the spread, assuming you recovered some of that 1 percent, why would we expect you to pass it along to consumers as opposed to increasing your profit rate.

Mr. HAMMONDS. Okay, I think you referred to some numbers from 1983 to 1991, if I recall.

Mr. NADLER. 1993.

Mr. HAMMONDS. To 1993. I think those numbers would have been right up until that period of time. I think if you look recently, particularly at the bank card industry, you would find that margins are down very significantly; that a 2 percent kind of return is something that would be an average probably for the credit card industry, where back in those days it was more like 4 percent. There are many bank card——

Mr. NADLER. Well, wait a minute. From 1983 to 1993, you say those figures were more or less accurate.

Mr. HAMMONDS. Right.

Mr. NADLER. So there was an 1,800 percent——

Mr. HAMMONDS. Well, you are speaking of our stock price now, not profits.

Mr. NADLER. Well, which indicates the profits. I am talking about both. The spread earned by credit card operations was three to five more times profitable than other banking operations in that time period.

Mr. HAMMONDS. I think prior to 1993, they were more profitable than other kinds of bank products; they are not today.

Mr. NADLER. And prior to 1993, the credit card interest rates did not come down, did they?

Mr. HAMMONDS. Yes, they have come down. They were——

Mr. NADLER. Prior to 1993?

Mr. HAMMONDS. Well, prior to 1993, average credit card rates were about between 18.9 and 19.8, and today they are about 16 percent, as you accurately stated.

Many banks have exited the bank card business. There are many fewer issuers in the country today than there ever have been. There are many people in this business that are losing money, but

many of the big banks are today exiting this business because, on the margin, it is a lot less profitable.

A big part of that is credit losses. You are right about cost of funds are 5.5 percent. Credit losses have averaged about 6 percent over the last 2 years. About half of that——

Mr. NADLER. I thought you said it was 1 percent?

Mr. HAMMONDS. Only 1 percent of the customers charge off, but their balances tend to be two to three times as high as the average balance. So it accounts for about 3 percent of the average outstandings, but it is only 1 percent of the credit card customers that are causing that, and then there is another 3 percent in credit losses from nonbankrupt. So your biggest cost in the credit card business today is credit losses and bankruptcy——

Mr. NADLER. Very briefly, please tell me why we would expect any savings from this would be passed along to consumers, since, obviously, the spread has been huge and it has been obvious that credit card interest rates have not really come down when the cost of money has really come down.

Mr. HAMMONDS. Well, I would not say a 1 to 2 percent spread is huge, but interest rates today on credit cards are higher than they should be with a 5.5 percent cost of funds because credit losses are higher, primarily driven by bankruptcies.

Mr. NADLER. Judge Kenner, Mr. Hammonds states in his testimony that legislation we have before us will reduce litigation. In your experience, what would be the result of allowing creditors to bring new motions against debtors—for example, allowing the creditors to bring 707(b) motions?

Ms. KENNER. Right now, as you know, 707(b) motions can only be, essentially, initiated by the bankruptcy court or the United States Trustee. I see a danger in expanding this—and I think this is the same danger that Congress recognized when it restricted section 707, the current law, to the U.S. Trustee and the judge. I think there is a danger that some debtors may become embroiled in litigation that they simply can't understand or defend against.

Most of the debtors that I see before me on a day-to-day basis don't have lawyers. They are intimidated by the process. They are scared. A lot of times when creditors bring nondischargeability actions against them, they simply default. They just don't show up in court.

Mr. GEKAS. The time of the gentleman has expired. The gentleman from Tennessee is allotted the customary 5 minutes.

Mr. BRYANT. Thank you, Mr. Chairman, and I thank the very distinguished panel for being here. You certainly provide a variety of opinions on a very important issue.

I was interested in Mr. Klein's statement that we really don't have a bankruptcy problem as much as we have a bad loan problem. I think that is an important statement. But I see people from the credit union here. Mr. Nuss, you represent the National Credit Union Association. I know they tend to be very conservative. I just wondered what your reaction would be, in terms of how you see the bankruptcy trends going, to Mr. Klein's statement that these are all bad loan problems, that you are not screening people enough and evaluating credit well.

Mr. NUSS. Thank you, Congressman.

We are conservative. If I may speak from the perspective of Cedar Falls community, we require written applications for any credit extension. We have a very conservative credit committee policy, if you will. Since 1998, we have had a Visa credit card program in our credit union. Essentially, we have evaluated, or our board of directors has evaluated, and considered the good payers, if you will, that on occasion we would automatically increase their line of credit. But our board, being conservative—and I go back to my statement of we are concerned about the members' financial welfare, and we thought, without individually underwriting each increase in a line of credit, we would be failing the member and failing our philosophy.

Mr. BRYANT. But you are still seeing bankruptcies files?

Mr. NUSS. Right.

Mr. BRYANT. Because I think he makes a fair comment there. I want to hear it from the credit union perspective. You would respectfully disagree somewhat?

Mr. NUSS. Yes.

Mr. BRYANT. At least as far as your credit union goes?

Mr. NUSS. Right.

Mr. BRYANT. All right, let me go now, if I could, to Mr. Sheaffer. You represent the National Federation——

Mr. SHEAFFER. I do.

Mr. BRYANT [continuing]. Of Retailers.

Mr. SHEAFFER. Right.

Mr. BRYANT. Now, again, I assume your clients use credit cards, too. But are there other ways, the old-fashioned credit way, you know, people refinance—you finance through banks and recourse with the banks, and those kinds of loans, and so forth?

Mr. SHEAFFER. Some of the retailers do, in fact, do that.

Mr. BRYANT. Do you see people filing bankruptcies who have gone through that particular process as opposed to using a credit card?

Mr. SHEAFFER. Well, I can only speak for my own perspective at Boscov's directly. We do all of our own credit card application processing internally. In addition to that, we have a very aggressive program to monitor our existing customers. We find, much like the banks, that bankruptcy is coming not from brand-new customers that are establishing accounts, but, rather, from customers that have been on the books for years and years.

So because of this huge increase in bankruptcy, we have had to actually tighten our credit standards quite significantly over the past few years. Unfortunately, that affects the blue-collar worker that is looking to buy the washing machine to replace the one that they need, or it affects the older customer that may never revolve and may never pay us a finance charge on our card, but, instead, carries our card because they are afraid to carry cash. Those are the types of people that we are having to affect, people that are still our customers. Whether they buy with Mr. Hammonds' credit card, whether they purchase with my credit card, or whether they purchase with cash, they walk into my store to buy our merchandise. Those are the types of people we are having to affect because of this bankruptcy issue.

Mr. BRYANT. Okay. I have one other question, but I wanted each member to respond, and it would probably take too long.

But, just a quick run down—one, two, three, four, five—just why are people filing bankruptcy so much? Just very quickly.

Mr. SHEAFFER. Lack of stigma.

Mr. BRYANT. Lack of stigma.

Mr. Hammonds?

Mr. HAMMONDS. Well, I think there is some percentage of people that lack of stigma affects. I think the majority of people who file bankruptcy, in fact, need bankruptcy. If we make a bad loan, nobody is asking for relief from that. If we have made a bad loan, and the customer doesn't have the capacity to repay, and they ought to be discharged to chapter 7. But it is that small percentage of people that file that have the ability to repay that we are asking to not impact our underwriting system and to put those into chapter 13.

Mr. BRYANT. Okay. Judge Kenner. I know there are a lot of reasons, but just the best——

Ms. KENNER. There are a lot of reasons. I am surprised; I agree with Mr. Hammonds. The people who file bankruptcy—the 1.4 million, or whatever it is, those are people who need to be there, by and large. I see scoundrels in bankruptcy court, but the number of scoundrels is very small. So I don't see that the system is being grossly abused by debtors.

Mr. BRYANT. Okay. Mr. Nuss, very quickly.

Mr. NUSS. Thank you. We see a number of issues, some of them divorce, unemployment, but late last year I ran across an interesting comment by a presenter at a multi-state seminar that said that some research that he had participated in said that the actions and the activity and the approach of collection people sometimes drove people to the brink, rather than being able to negotiate a compromising position, where a member in our case, debt rating could be preserved by making some other arrangements.

Mr. BRYANT. Mr. Klein, you have the last word.

Mr. KLEIN. Congressman, I think the simplest way I can say it is that the family budget is a fixed pie, and everybody wants a bigger and bigger piece out of that pie. If a family gets three credit cards, the interest on those cards takes a bigger and bigger piece out of that budget, and eventually, if there is a continuing pressure on that family and more marketing of additional credit, the budget is going to bust. That is what I see going on over and over again.

Mr. BRYANT. Could I have one quick final question to Mr. Klein?

Mr. GEKAS. Without objection.

Mr. BRYANT. Thank you, Mr. Chairman.

Mr. Klein, you were here when Mr. Moran testified about apparently a new provision in this bill that would give more of a disclosure as to what you would be paying in a credit card if you paid minimum payments. Would you agree that that is a good first step or step in the right direction?

Mr. KLEIN. Congressman, the provision that passed the Senate was a good provision on that issue. It was a very powerful provision which would have actually given people information they need to make responsible credit decisions.

The provision in H.R. 833 actually would mislead people because it is based on a $500 balance and a set of assumptions that wouldn't prove accurate for those people that are going to be in the bankruptcy system because they have a $7,000 or a $10,000 or a $20,000 balance on their credit cards as a whole. So it has to be based on the actual circumstances that apply to that individual's debt.

Mr. GEKAS. We will change that provision and ask you for support of the bill. [Laughter.]

Mr. KLEIN. I would suppose we would be supporting that if you do.

Mr. GEKAS. The time of the gentleman has expired. The Chair recognizes the lady from Wisconsin for 5 minutes.

Ms. BALDWIN. Thank you, Mr. Chairman.

I am one of the newcomers to this subcommittee who did not go through this debate last session, being a newcomer to the Congress, too.

Judge Kenner, I was amazed to think that you had presided over 35,000 bankruptcy cases.

Ms. KENNER. I am actually much younger than I look. [Laughter.]

Ms. BALDWIN. I practiced law briefly and assisted a client with one bankruptcy in my career.

Your testimony focused mostly on reaffirmations. It would help me if I could have your perspective as a judge on the likely success of the means test that is part of the bill that we are considering.

Ms. KENNER. Well, Congresswoman Baldwin, I am not really familiar with the intricacies of how it works, but if you set a threshold of $51,000 annual income for a family of four, I predict that that will not affect my caseload one iota. If that is what you choose, I don't think it is going to make a difference. The reason is that my perception is that my chapter 7 debtors simply can't pay. I agree with Chairman Gekas that people who can pay should pay. I think that is fundamental. But my experience in the bankruptcy court tells me that, by and large, these debtors can't pay. My chapter 13 cases are failing at an amazing rate. So I just don't see that the ability is there.

Ms. BALDWIN. I wanted to follow up on one of the last questions, the reasons for the increase in numbers of filings. One of the things I heard in your testimony, or various testimony, is there some difference in perception of, say, the percentage of "scoundrels" among all, as they were termed.

For example, Mr. Sheaffer, in your testimony I thought I heard a little dissonance in your saying at one point that very few of those people who actually file for bankruptcy are doing so with a lack of real crisis in their life. Yet, in some of your other testimony, I think you were indicating that half of your filers, as you reviewed the files last year, were not seriously delinquent in their cards. I don't know if I should take the jump to say that you are doubting that there is a serious financial crisis in their life or not, but I wonder if you would explain that inconsistency.

Mr. SHEAFFER. No, I don't think it is an inconsistency. What we see, as a very local retailer that is very involved in our communities, is that our customers tend to make an extra effort to pay

us, and we are very fortunate in that. Don't get me wrong; I absolutely agree with my fellow panelists. The huge majority of those who file bankruptcy absolutely need relief and should get that relief. The number, depending on who you talk to, the number goes from 3 percent to 15 percent. But even if the number is 3 percent, you are talking about not 10, but 30,000 people that can repay some or all of their unsecured debt. All that we are really asking is that they are compelled to repay what they can repay.

When I say that half of our customers that file bankruptcy were not seriously delinquent, I mean with us. I don't mean with anybody else. In our particular case, we are very fortunate in that our customers are very loyal to us.

Ms. BALDWIN. And you would not, from your paper records, have any ability to see if there is a health crisis or some other crisis?

Mr. SHEAFFER. No, no, we see health crises; we see divorce; we see automobile accidents; we see lack of insurance as the primary driver into bankruptcy. But there is still a group of people for whom the billboards that say, "Question: Money problems?", "Answer: Bankruptcy," those types of messages that are being conveyed to them are compelling them to use bankruptcy not as the safety net that it was initially intended to be, but, rather, as a financial planning tool. Rather than trying to work with the creditors or trying to work with consumer credit counseling services, they see an easy way out, and they are using this as a financial planning tool. But it is a very small segment of the customers.

Mr. NADLER. Mr. Chairman?

Mr. GEKAS. The time of the lady has expired. For what purpose does the gentleman——

Mr. NADLER. I ask unanimous consent for 1 minute to ask one question.

Mr. GEKAS. Without objection.

Mr. NADLER. Thank you.

I would just like to ask Mr. Klein to reply to the question that Ms. Baldwin asked about the effect of the means test in this bill.

Mr. KLEIN. The means test is two pages of a 302-page bill, Congresswoman, and I agree with the rest of the panelists that, if there are people in the system who can pay, they should pay. I think we can make the means test better and make it workable. But on the 302 pages of this bill there is something on almost every page that advantages lenders and disadvantages debtors. The sum total of those provisions will be to raise the cost of filing because debtors will have to pay more to their attorneys; they will have to pay more to use the system, because creditors will have more weapons to get them, force them, or coerce them to pay back their debt. That just hurts the people at the bottom. The people who have the most need to be in the system are going to be the ones who are least able to afford the more complicated and expensive relief that will be required.

Mr. GEKAS. The time of the gentleman has expired.

We want to thank the panel. You got us off to a rousing start with some controversy and with some humor. We expect that it will serve as a foundation for future debate on this issue. Thank you very much.

This is a propitious time for us to recess to accord the members the privilege of voting on a pending measure on the House floor. We expect to return to this chamber at 20 after 4. We are recessed until that time.

[Recess.]

Mr. GEKAS. The time of 4:20 having arrived, the recess has expired, but we are unable to proceed until one other member should arrive, pending which time we enter into another recess.

[Recess.]

Mr. GEKAS. The subcommittee will reconvene. The lady from Wisconsin has joined us to constitute the hearing quorum.

We welcome the panel. Judge Edith Hollan Jones was appointed to the United States Court of Appeals for the Fifth Circuit in 1985. She played an active role in studying our Nation's bankruptcy laws as a member of the National Bankruptcy Review Commission. She has also served on the Advisory Committee on Bankruptcy Rules to the Standing Rules Committee of the Judicial Conference of the United States. Judge Jones has testified on bankruptcy issues before the Senate, as well as before the House, on several occasions.

Judge Jones received her B.A. in economics in 1971 from Cornell University. She then went on to study at the University of Texas School of Law, where she was the editor of the Texas Law Review and graduated with honors in 1974. Prior to joining the Federal bench, Judge Jones was a partner at the Houston office of Andrews and Kurth. Her areas of practice included bankruptcy law. Judge Jones is a member of the Texas Bar Foundation and the American Law Institute.

She is joined by Judith Greenstone Miller, Esquire, of Birmingham, Michigan, who is here on behalf of the Commercial Law League of America. Ms. Miller received her juris doctor degree cum laude from Wayne State University of Law in 1978. Prior to that, she attended the University of Michigan, where she received her bachelor of arts degree, also cum laude, in 1975.

Ms. Miller's practice focuses on bankruptcy and insolvency matters, creditors' rights, and commercial litigation. Her practice involves the representation of secured and unsecured creditors, debtors, bankruptcy trustees, and chapter 11 reorganizations. She is a member of the Commercial Law League of America, its bankruptcy and insolvency section and its creditors' rights section. Founded in 1895, the Commercial Law League is the Nation's oldest organization of professionals engaged in the credit and finance industry. Its current membership exceeds 4,600 individuals.

Professor Todd Zywicki teaches bankruptcy and contracts at George Mason University School of Law, where he has been an assistant professor of law since 1998. Prior to joining the faculty at George Mason, he was an assistant professor of law at Mississippi College School of Law from 1996 to 1998. Professor Zywicki began his legal career as a law clerk for Judge Jerry E. Smith of the Fifth Circuit Court of Appeals.

Professor Zywicki received his juris doctor degree from the University of Virginia in 1993. He received a masters degree in economics from Clemson University in 1990, and his undergraduate degree cum laude from Dartmouth College in 1988. He has written extensively on the subject of bankruptcy, environmental law, con-

stitutional law and history, among other areas. Most recently, he has co-authored with Judge Jones a Law Review article entitled, "It's Time for Means Testing."

I should make that required reading for everybody in the room. [Laughter.]

Professor Elizabeth Warren holds the Leo Gottlieb chair at Harvard Law School. She has authored several books and articles on consumer and business bankruptcy issues. She has taught bankruptcy law and other business law topics at Harvard University, the University of Pennsylvania, the University of Michigan, and the University of Texas, among other institutions.

She was appointed by Chief Justice Rehnquist as a member of the Federal Judicial Center's Committee on Bankruptcy Education, where she planned and implemented educational programs for bankruptcy judges. Professor Warren served as the reporter to the National Bankruptcy Review Commission. In addition, she is active in several organizations, including the National Bankruptcy Conference, the American Law Institute, and the American Bankruptcy Institute. She is currently working on an empirical study of 3,500 business bankruptcy cases as a part of a study sponsored by the National Conference of Bankruptcy Judges.

I might add that Professor Warren is here, whether she realizes it or not, at my personal invitation; thus, indicating my masochism in that in the past I felt that some of your criticisms were aimed right at me, but that is just me. Don't worry about that. But you do have a lot to add to this critique, and that is why you are here.

Judge Jones, please begin with a 5-minute limitation.

STATEMENT OF EDITH HOLLAN JONES, JUDGE, U.S. COURT OF APPEALS FOR THE FIFTH CIRCUIT, AND MEMBER OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, HOUSTON, TX

Ms. JONES. Yes, sir, it is a great privilege and honor to be invited to speak to this joint session, even though some of the members are in absentia at the moment. You know I have very strong feelings on the subject of bankruptcy, and I am a very strong proponent of bankruptcy reform.

I would like to address four things briefly in my time here. First, an introductory statement about the importance of restoring personal responsibility and public accountability to our national bankruptcy system, and then on the specific subject of means testing: Why should we have it? How does it work? And what are the objections to it, or are they well-founded?

On the introductory matter, as earlier witnesses have told, our bankruptcy system today seems to be wildly out of control. I don't see how one can justify the filing of 1.4 million bankruptcies during a period of unprecedented economic prosperity and low unemployment. The answers, the reasons for these filings are very difficult to fathom in many instances, but a lot of them, in my view, deal with personal inability or lack of desire to control one's finances and with the lack of social stigma that is currently attached to bankruptcy.

The people who disagree with this view are the defenders of the status quo. They talk about reform. They have been very short on

proposing reforms that do anything other than limit the activities that creditors engage in, but they never face the consequences of two things. One of them is that unnecessary bankruptcy or manipulation of bankruptcy are not victimless events. They impose costs, not simply on the creditors, but also on the wives and children. Ex-husbands are prime users and abusers of the bankruptcy system today because they get an automatic stay, so they do not have to pay child support from the time they file. There is an entire volume of law review published by the family law section of the ABA devoted to advising how wives can find their way into the bankruptcy courts to save themselves. This bill (H.R. 833) dispenses with those problems and solves them.

There are also other problems of abuse that I don't have time to cover that are accounted for and largely remedied in this bill.

But the other burden that the defenders of the status quo don't bear is that they don't acknowledge that a system that runs with 1.4 million cases a year, and approximately 400 judges, is not a system in which discretion exercised by the judge means anything. They say, well, the judge ought to be able to decide in individual cases whether a certain person is abusing the law. I say, look at the way the law operates right now. You have mass hearings. You have dozens of debtors present at one hearing. Many debtors never even see the judge. It is a system in which there simply is not public accountability.

The telling proof of this is that no one in the bankruptcy system believes in the veracity of the debtors' statements of their assets and liabilities. Those are documents filed under penalty of perjury. If our tax system were that inaccurate, we would have no Federal Government. But nobody in the bankruptcy system and before our Commission defended the accuracy of the debtors' filings.

Why means testing? The short of it is—I have put several reasons down in my paper—the short of it is, means testing, as proposed by Congress, is a modest way to identify the small percentage of filers who are the most well off in American society, relatively speaking. They are all in the upper half of the American median family income, and therefore, they are the most able to determine and control their finances, the most able to live within their means, and the most likely to be abusing the system. One thinks of the profligate doctor or the bad real estate investor, for example.

How does means testing work? Major objections raised are that it is very difficult; that we can't understand it; that the judges are going to be overburdened. These are nonsense. This is a formula. The formula is income less expenses. Expenses are based on all secured debts that exist with that debtor and all living expenses, according to a formula that the IRS uses every day to negotiate repayment plans. There is computer software already in a test model that puts the information in the right places and automatically tells whether a debtor is going to qualify or not.

No more than 20 percent of Americans who file bankruptcy will even be eligible for consideration under the means test. It is easily administrable. It will not impose a burden, an undue burden, on judges because the issues will be well-framed for them to decide.

Among the objections, the other objections to means testing are that nobody can really afford to pay. Well, again, how can it be that Americans who are in the top half of the median of all Americans cannot afford to repay a single dime to unsecured nonpriority creditors? That doesn't make sense on the face of it.

But the bill has a hardship provision. So it doe have a form of clemency that can be exercised.

I see that my time is up. I have a lot more to say later on.

[The prepared statement of Judge Jones follows:]

PREPARED STATEMENT OF EDITH HOLLAN JONES, JUDGE, U.S. COURT OF APPEALS FOR THE FIFTH CIRCUIT, AND MEMBER OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, HOUSTON, TX

Distinguished Senators and Representatives, it is an honor to testify before you today on a subject dear to my heart, that of bankruptcy reform. These remarks support H.R. 833, captioned "The Bankruptcy Reform Act of 1999". As you are aware, I served for two years on the National Bankruptcy Review Commission, which studied the status of the 1978 Bankruptcy Code and the system it has engendered. When I was in private law practice, I was a specialist in bankruptcy law. Among the articles I have published is one with Professor Todd Zywicki called "It's Time for Means-Testing," forthcoming in B.Y.U. Law Review (Feb. 1999) (copy attached).[1]

The major theme of my presentation is simple: I strongly favor means-testing bankruptcy relief for well-off, income-earning debtors, as I believe such a device is necessary both to restore personal accountability to bankruptcy and to instill public confidence in the system. In addition, as a subsidiary theme concerning judicial administration, I strongly urge Congress to allocate the function of collecting data in bankruptcy cases to the United States Trustees' office, and I advocate streamlining bankruptcy appeals to the United States Courts of Appeals.

I. THE NEED FOR BANKRUPTCY REFORM

The enormous support demonstrated by both Houses of Congress for bankruptcy reform legislation in 1998 evidences your awareness of the problems in the bankruptcy system. Only a few vivid reminders of the need for reform will serve as a preface to my defense of means-testing. In 1998, over 1.4 million people filed personal bankruptcy cases, representing approximately one in each 70 American households. To put this number in perspective, in six months in 1998, many more people filed for bankruptcy than during the entire decade of the Great Depression of the 1930's. The number of filings has risen well over 50% in the 1990's alone despite unprecedented economic prosperity and low unemployment.

The current system of bankruptcy law permits any person to seek relief without demonstrating financial necessity. At one time in our history, filing bankruptcy was regarded as shameful, and filers suffered social stigma and permanently ruined credit. The shame and stigma are no longer compelling, and creditors cater to the euphemistically named "sub-prime" market. According to testimony before the National Bankruptcy Review Commission, many filers now commence cases without ever having been in default on their debts. This suggests that bankruptcy is, to them, not a last resort but a first resort. Many debtors are well-off and continue to be fully employed before and after filing bankruptcy. Lawyer advertising, do-it-yourself kits, and bankruptcy mills expand the pool of potential filers. Well-publicized celebrity bankruptcies, plus "water cooler" gossip about increasing filings, have tended to reduce bankruptcy to an acceptable alternative for personal financial management.

The integrity of the bankruptcy system has suffered from the increased filings, because bankruptcy professionals are no longer able to devote individual attention to the cases. Administrative oversight is ineffective. Most debtors never see a judge. Only very recently has the Justice Department begun to prosecute bankruptcy fraud vigorously, and egregious cases are being discovered. But even when there is not outright fraud, there is frequent abuse and manipulation. Debtors routinely shade the descriptions of assets and liabilities on their schedules and statements of affairs so that no one in the bankruptcy system believes their filings are trustworthy. This

[1] Any earlier testimony in Congress, on which some of these remarks are based, may be found in Symposium on Bankruptcy Reform, 52 Consumer Fin. Law Quarterly Report, Spring 1998.

is true, notwithstanding that debtors' disclosures are made under penalty of perjury. Other types of abuses include filing multiple bankruptcies; filing to forestall eviction or foreclosure; purchasing new vehicles just before bankruptcy; pre-bankruptcy loading-up on consumer purchases; and moving to jurisdictions with favorable homestead and personal exemptions. Other common abuses include filings by husbands who wish to delay making their child support and alimony payments; by tortfeasors who wish to discharge liability, e.g. medical malpractice, verdicts; and by perpetrators of fraud who seek to "reorganize" their liabilities through Chapter 13 cases.

Although lenders' practices do not always fulfill our ethical expectations, I am convinced that consumer lending practices, especially by credit card issuers, are not the cause of the inordinately high bankruptcy filing rates. That argument is a red herring, designed to divert attention from the fraud and abuses that are occurring and from the problems of personal responsibility that lie at the heart of many bankruptcies. I would be happy to delve into this mischievous argument at greater length, as it is addressed in my article with Professor Zywicki, but it should not distract us from the means-testing debate.

Now is the optimum time to reform bankruptcy laws. If and when our economy turns down, I fear that the number of bankruptcies could spiral rapidly and could suddenly multiply business losses, devastating our consumer credit system. The impact of bankruptcy on our economic system as a whole should never be underestimated.

II. MEANS-TESTING

A. Why Means-Testing?

The theory behind means-testing is simple: well-off, income-earning debtors ought to repay some of their unsecured, non-priority debts in exchange for the privilege of obtaining a fresh start. Ability-to-pay should be just as relevant to the availability of bankruptcy relief as to one's income tax bracket or eligibility for social welfare programs of all kinds. Opponents of means-testing never explain why ability to pay is uniquely irrelevant to bankruptcy, especially where, as here, Congress has carefully limited the group to which means-testing will apply.

Means-testing is justified for several other reasons. First, bankruptcy relief should be tailored to the honest but unfortunate debtor. It is neither moral nor economically sound for our society to permit the breaking of contracts willy-nilly for the sheer convenience of the individual. Second, when bankruptcy is abused by those who are able to repay part of their debts, the costs are passed on not only to the particular creditors, but also to the rest of the public in the form of higher costs for goods and services and consumer credit. Bankruptcy is not a victimless act. Third, lower-income people and minorities are particularly harmed by unnecessary bankruptcies. They bear the brunt of the higher credit costs that result. And while they are struggling to live within their means and pay off their debts, others are taking advantage of debt relief through bankruptcy. Bankruptcy serves its laudable social goal when it is reserved for those who truly deserve and need debt relief.

Fundamental social goals will be served by inaugurating Congress's modest means-test for bankruptcy relief proposed in The Bankruptcy Reform Act of 1999. Public confidence in the bankruptcy system as a refuge for the needy, rather than a haven for the crafty, will be restored. Personal responsibility will be reinforced for those who, because they are relatively well off, should repay some of their debts.

B. How Means-Testing Works

H.R. 833 is the same as last year's Conference Committee bill. Under this bill, panel trustees will review Chapter 7 liquidation petitions as they are filed. If a debtor's family income exceeds the median American income for a family of comparable size (about $51,000 for a family of four), the debtor may be eligible for means-testing. The trustee will next review the debtor's living expenses. The living expenses will include actual monthly payment obligations on secured debt, other standardized expenses determined according to criteria utilized by the Internal Revenue Service, and priority expenses such as child support and alimony payments. If, after deducting the living expenses from the debtor's income, there is enough monthly income remaining to pay at least $5,000 or 25% of the debtor's unsecured, non-priority debts over five years, then and only then is the debtor subject to means-testing. At that point, the trustee will file a § 707(b) motion with the court seeking to dismiss the Chapter 7 liquidation case. The debtor then has the options of proceeding in Chapter 13 or 11 or not pursuing bankruptcy.

The test set out in H.R. 833 creates a rebuttable presumption, which the debtor may defeat "only by demonstrating extraordinary circumstances that require additional expenses or adjustment of current monthly total income."

The means-testing formula, in short, is largely mathematical, lends itself to information processing techniques, covers only a few of the debtors who file bankruptcy each year, and has an escape hatch for truly deserving filers.

C. Objections to Means-Testing

Critics of means-testing are inexplicably hostile to the philosophy behind it, which I have tried to explain in a preceding section. Worse, they seem ill-informed about the operation and impact of the new law. In this section, I hope to clarify some of the misconceptions.

First, the means-testing proposal contained in H.R. 833 carefully targets only those debtors who are in the top half of comparable American families. It has been objected that means-testing will not be fruitful, because "no one" who files bankruptcy can afford to repay debts. Studies have accumulated which demonstrate contrary propositions. A VISA survey of bankruptcy filers between 1988 and 1996 revealed that people who earned over $45,000 annually increased from 9% to 23% of the filers. The WEFA group, analyzing a stiffer means-testing formula introduced in the House of Representatives last year, estimated that between 3.6 dnd 7.4 billion dollars of debt could be repaid if the covered debtors proceeded in Chapter 13 reorganization cases. Other studies are described in our attached article. The amount of debt likely to be repaid under H.R. 833 will be smaller, because of its narrower scope, than studies based on different proposals. Nevertheless, the returns should be substantial.

Second, if it were correct that "no one" who files bankruptcy has the ability to repay debts, that would probably mean that "no one" would qualify for means-testing under H.R. 833. It is contrary to human nature, however, to suppose that when the government offers a "free" discharge from debt, no one will take undue advantage of the system. The real question is how best to identify those who are misusing bankruptcy and to make them pay for the privilege.

Third, is means-testing "unfair"? I think not, because it is a *progressive* reform in the same sense that our income tax system is progressive. The more one has the ability to repay, the more he ought to repay his debts while obtaining bankruptcy relief. It is not "unfair" to impose a price on higher income-earning debtors for the benefits they receive from filing bankruptcy.

Fourth, the modest means-test incorporated as an amendment to § 707(b) of the Bankruptcy Code will not impose undue costs and burdens on the judiciary, on trustees or on attorneys. Last year, Professor Carl Felsenfeld of Fordham Law School and attorney William Perlstein of Washington, DC, created a software program that, given proper information about a debtor's affairs, would automatically calculate the debtor's eligibility for Chapter 7 liquidation or a Chapter 13 payment plan. Such software is easily usable by all professionals in the bankruptcy system. The initial responsibility for complying with the means-test will fall upon debtors' attorneys, as they have an ethical duty to advise their clients how to file cases properly. Although H.R. 833 states that the panel trustee or bankruptcy administrator must review petitions for their amenability to means-testing, forms can be promulgated which incorporate the available software and yield the correct answer at a glance. Trustees ought to be able to rely on the data gleaned from the attorneys' official work sheets. Finally, judges will not have to reconstruct the debtors' financial condition themselves. By the time a motion for § 707(b) relief is litigated, the precise contested issues will be framed for the court. The court will be able to review the underlying summaries of relevant financial information.

Some short-term costs will be incurred while the details for administering the law are worked out and initial ambiguities are resolved by judicial decisions, but similar costs accompany any new statutory system. Moreover, means-testing will be relevant for at most perhaps ten to twenty percent of consumer filers, since the vast majority of petitions on their face will not qualify. If increased costs are significant, they can be defrayed by higher filing fees or trustee fees for eligible debtors.

Fifth, some argue that means-testing "can't work" because debtors' schedules are unreliable. This objection essentially admits that the present system lacks effective oversight. If debtors are smart enough to "game" the system, they must be understating their assets and ability to pay. H.R. 833 enhances the reliability of debtors' filings by requiring pay stubs, tax returns and other documents to be furnished timely to the trustee and by requiring random audits.

Sixth, some critics of means-testing target as "inequitable" the use of standardized levels of living expenses. These schedules of expenses are already used by government agencies, and they are adjusted geographically. In the present bankruptcy system, each court must determine for itself whether a debtor's "lifestyle" expenses, such as private school, club memberships, or cellular telephones, are too extravagant. In fact, bankruptcy judges routinely complain about making these judgment

calls. Substituting rough consistency for the discretion and preference of each bankruptcy judge does not seem unfair.

Seventh, it is said that means-testing will be manipulated and that debtors will increase their expenses or secured debt or reduce their income in order to avoid the test. To the extent this criticism is correct, it indicts the current system as well by admitting that gamesmanship can and does occur. But the criticism is misplaced. If debtors flagrantly evade the means-test formula, they and their attorneys should be held to account and sanctioned. Even more important, there will only be disputes about means-testing in a small proportion of cases, and there is correspondingly little room for evasion. Further, debtors' efforts to evade means-testing would be self-defeating.

Eighth, a final objection is that means-testing will not work because Chapter 13 "doesn't work," inasmuch as most debtors never complete their payment plans and receive a discharge. This criticism overlooks the differences between current Chapter 13 debtors and those who would be covered by means-testing. The well-off, income-earning debtors have a lot more to lose if they fail to receive a discharge, and their incentives to complete their Chapter 13 payments are greater. As. H.R. 833 imposes limits on repeat filings, well-off debtors would have to exercise care in their affairs.

III. BANKRUPTCY DATA COLLECTION

H.R. 833 directs the federal courts to compile data and statistics concerning bankruptcy cases that will be generally useful for researchers and policy makers. This responsibility should, however, be placed in the hands of the U.S. Trustees, not the courts. The federal courts' mission is to administer justice and decide cases. It is not the courts' proper function to assist or participate in social science data-gathering. The courts have never been asked to assemble such data before. Consequently, as a matter of principle, the Judicial Conference of the United States has decided that the collection of such data, if desired by Congress, should be assigned to the United States Trustee system instead. As a matter of practicality, the U.S. Trustees are better equipped to collect the data that are of interest to Congress and policy researchers, and they are in a better position to address privacy concerns.

IV. DIRECT APPEALS

Bankruptcy law is unduly vague and complex because there is no effective system of precedent in place. Bankruptcy decisions must be appealed first to federal district court and then to the courts of appeals. The delays and costs of this pilgrimage are more than most parties can afford. As a result, it is extremely difficult to pursue cases that will yield circuit-wide precedent. The bankruptcy courts routinely operate on conflicting legal premises.

The only solution to this problem is to facilitate appeals to the courts of appeals. Several proposals have come forward. I personally favor avoiding district court review wherever possible and utilizing a model based on appeals from magistrate judge decisions. Others have favored optional retention of bankruptcy appellate panels, with review available by the circuit courts. Yet others favor placing a time limit on district court handling of bankruptcy appeals. None of these proposals should be discarded out of hand. This issue is vital to achieving coherence in bankruptcy law. Every interested party and constituency in bankruptcy of which I am aware has advocated direct appeals.

Mr. GEKAS. The Chair now turns to Ms. Miller.

STATEMENT OF JUDITH GREENSTONE MILLER, REPRESENTING THE COMMERCIAL LAW LEAGUE OF AMERICA, BIRMINGHAM, MI

Ms. MILLER. Thank you. I am honored to appear before the committee today on behalf of the Commercial Law League of America. There are a number of comments I would like to make regarding the proposed needs-based testing.

Creditor standing under the proposed amended section 707(b) is limited. The size of the case should not impact creditors' standing to bring such motions. Abuse under the statute is defined by a specific rigid needs-based formula. No formula, however well-considered or crafted, can be flexible enough to encompass the endless

combinations or circumstances which debtors bring to the bankruptcy court. While intended to provide a very objective standard, such formulas have proven historically to be the source of much litigation focused at interpreting and defining all of the parameters.

The bill does not grant the court any discretion to determine whether a debtor with sufficient income under the needs-based formula should, nevertheless, be allowed to remain in the chapter 7 proceeding. The 5-year period for calculation of the debts is longer and inconsistent with the 3-year period currently provided for repayment of obligations under a chapter 13 plan. The standard to rebut the presumption, extraordinary circumstances, is rigid, onerous, and likely to lead to increased litigation.

The National Bankruptcy Review Commission conducted an extensive study and analysis of consumer bankruptcies. Ultimately, though, they did not recommend the adoption of a needs-based formula denying individuals in financial distress access to the court. Although bankruptcy filings have increased threefold during the last 20 years, one cannot necessarily conclude it is solely on account of debtor abuse, unwillingness of individual debtors to honor a promise to pay, or lack of social stigma.

A number of the empirical studies have indicated that the financial crises being experienced today are similar to those of families 20 years ago. These people have no hope of repaying their debts.

There are many factors that contribute to the filing of a bankruptcy, which have been alluded to today by other witnesses, whether it be layoffs, downsizing, medical bills, failed businesses, or having to take care of aged parents. The League concedes there is no agreement on the statistics or the reason for the increase. However, if you take the highs and the lows of the percentages being bantered about, anywhere from 3 percent to 6 percent that will be affected by the means test, you have to question the legitimacy of applying it across the board on a mandatory basis to 100 percent of the cases that are filed.

Trustees are being asked to review each case and apply the means test. This will unnecessarily burden the system, particularly when they are vested with substantial responsibility and paid a minimal fee.

If you only affect 6 percent of the cases, why require the trustees to perform work in 100 percent of the cases? Moreover, you require the calculations be done 5 days before the first meeting of creditors. If, in fact, as everybody concedes, the schedules are not accurate, wait until the first meeting of creditors take place. Let the trustees do their job, to ask the questions that they need to find out about the true essence of the estate, and then determine whether or not there is abuse that justifies the means application.

The means test further operates to the exclusion of the trustee's significant avoidance powers. If the trustee finds that there have been avoidable transfers that could be brought into the estate, if the person doesn't qualify under the means test to be in chapter 7, then they can't go after those assets and bring them back into the estate.

The proposed means test also invites manipulation by debtors to fit within the standard. Individuals with secured debt are allowed

deductions for secured obligations prior to calculating their debt. Also, they could go out and get a second mortgage or a new car and finance it before filing in order to reduce the income available so they don't qualify. Also, they could make contributions to charities, 15 percent of their income, which wouldn't be calculated as part of the income.

The League is sensitive to the concerns of sanctity of contract and moral obligation to honor promises raised by Judge Jones, but the means test does not remedy the problem and will preclude too many honest debtors and first-time debtors from obtaining redress.

Congress is operating from the premise that filing bankruptcy is per se abusive. Rather, the focus of Congress should be on debtors who abuse the system by serial filings and those provisions of the Code which encourage abuse of the system, such as unlimited exemptions. Ultimately, the courts should be given the tools, the totality of circumstances, including consideration of a discretionary, flexible means test, and the express authority to determine when abuses are present and how such abuse should be remedied.

The concept of a fresh start and maintenance of the delicate balance between the debtor's rights and creditors' remedies must be preserved. Under the current Code, the courts do not have the authority to affirmatively look for abuse or fashion an appropriate remedy except in the most egregious circumstances. Adoption of the totality of circumstances test, in conjunction with the discretionary means test, would represent a major change and a vehicle by which abuse could be addressed and remedied.

Although we do oppose the means test as currently drafted, we recognize there is abuse in the system that has to be addressed; we also recognize that there are a number of provisions that are proposed as part of the Bill that are fair and will help to maintain a balanced system. We are committed to continuing to work with Congress in that regard.

Thank you.

[The prepared statement of Ms. Miller follows:]

PREPARED STATEMENT OF JUDITH GREENSTONE MILLER, REPRESENTING THE COMMERCIAL LAW LEAGUE OF AMERICA, BIRMINGHAM, MI

I. INTRODUCTION

The Commercial Law League of America (the "League"), founded in 1895, is the nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the fields of commercial law, bankruptcy and reorganization. Its membership exceeds 4,600 individuals. The League 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 involved.

The Bankruptcy and Insolvency Section of the League ("B&I") is made up of approximately 1,600 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 League has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization fields.

The League, its B&I Section and its Legislative Committee have analyzed the "needs based" provisions of H.R. 833, the Bankruptcy Reform Act of 1999 (the "Bill"). The League supports changes to the Bankruptcy Code (the "Code") to limit possible abuses by debtors and credit grantors. Any proposed change will have consequences on the system. It is the goal of the League to help Congress carefully consider the practical implications of each change in order to maintain the delicate balance between the debtors' rights and creditors' remedies and to effectuate fair treatment for all parties involved in the process.

II. ANALYSIS OF SECTION 102—DISMISSAL OR CONVERSION; THE "NEEDS BASED" PROVISION OF THE BILL

This section of the Bill provides the circumstances under which a Chapter 7 proceeding can be dismissed or converted by the Court. Congress has proposed to substantially modify Section 707(b) of the Code as follows:

- Creditor standing to bring motions under Section 707(b) is limited under the proposed legislation. While the League recognizes that the limit is reasonable as drafted, nevertheless, the League believes that the size of the case should not impact creditor standing to bring such motions.
- A case may not be converted to Chapter 13 without the debtor's consent. The League believes that it is appropriate to grant the Court discretion to convert a Chapter 7 proceeding irrespective of the debtor's wishes if the debtor falls within the parameters of the "needs based" provisions, particularly when the debtor has received the benefit of the automatic stay during the interim period. The League recommends that after conversion to Chapter 13, the debtor should be given the right to dismiss the case during a 20-day period from the date of the conversion. The right to dismiss should not be subject to the discretion of the Court.
- "Substantial abuse," as the standard for dismissal has been changed simply to require "abuse." The League believes that the standard should remain "substantial abuse."
- "Abuse" is defined by reference to specific, rigid "needs based" formula, when, in reality, as recognized by Congress, "abuse" may be found to exist based upon a review of the totality of circumstances surrounding the filing. See e.g., subsections 3(A) and (B). No formula, however well considered or crafted, can be flexible enough to encompass the endless combinations of circumstances which debtors bring to the bankruptcy court. While intended to provide a very objective standard, such formulas have proven historically to be the source of much litigation focused at interpreting and defining all of the parameters of the standards. A better approach would be to draft general standards or a more expansive definition of "abuse," which would include, but not be limited to, a finding of "abuse," based on a needs based formula, bad faith or specific behavior or activity. Ultimately, the Court would be required to make a finding after a review of *all* of the facts and the totality of circumstances surrounding the filing of the petition.
- The Bill does not grant the Court any discretion to determine, based on a totality of the facts and circumstances, whether a debtor who has sufficient income under the needs based formula should, nevertheless, be allowed to remain in a Chapter 7 proceeding. The League believes that courts do a good job generally of exercising discretion in individual cases, and therefore, such discretion should continue to be vested in the courts.
- The 5-year period required for calculation and determination of whether a debtor falls within the needs based formula is too long and inconsistent with the 3-year period currently provided in the Code for repayment of obligations under a Chapter 13 plan.
- The standard to rebut the presumption, e.g., "extraordinary circumstances," is rigid, onerous, and likely to result in increased litigation over the evidence necessary to prove compliance with this standard. Moreover, subsection 2(B) requires the "extraordinary circumstances" to be evidenced by an itemized, detailed explanation, proving that such adjustment is both necessary and reasonable, and the accuracy of the information provided in the explanation must be attested under oath by both the debtor and its attorney. This verification requirement by the debtor's attorney is inappropriate, unreasonable and appears to go beyond the parameters of Federal Rule of Bankruptcy Procedure 9011 and Federal Rule of Civil Procedure 11.
- The needs based formula requires that "current monthly income" be calculated on the basis of all income, from all sources, regardless of whether taxable, received within 180-days from the commencement of the proceeding. The 180-day period may be too short to obtain an accurate review of the debtor's available sources of income, and may also be susceptible to manipulation. The League, therefore, recommends that the assessment period be redrafted to be one year from the date of the commencement of the bankruptcy proceeding.
- Congress has created a new and different standard for the award of fees and costs associated with the bringing of a motion to dismiss or convert under Section 707(b). There is no need to create a new standard, e.g., "substantially

justified," when sufficient standards for such relief already exist under Federal Rule of Bankruptcy Procedure 9011 and Federal Rule of Civil Procedure 11. Appropriate sanctions are already available when it can be demonstrated that a creditor has filed a Section 707(b) motion solely for the purpose of coercing the debtor into waiving a right guaranteed under the Code. Moreover, the potential imposition of penalties on the attorney for the debtor if the case is deemed abusive will likely translate into increased costs and fees attendant to preparation and filing of a bankruptcy petition. Lastly, subsection 4(B) exempts a creditor with a claim of less than $1,000 from the imposition of costs and fees. The amount of one's claim should not be a consideration in the award of fees and costs by the Court.

III. THE PROPOSED "NEEDS BASED" CHANGES DO NOT WORK, WILL NOT CURE THE PERCEIVED ABUSES TO THE BANKRUPTCY SYSTEM AND WILL OVERBURDEN AND TAX THE SYSTEM

The National Bankruptcy Review Commission (the "Commission") conducted an exhaustive study and analysis of consumer bankruptcies over the period it was created by Congress. While the Commission recognized the import of a promise to pay, it also acknowledged the need for appropriate relief for those in financial trouble and equitable treatment for creditors within a balanced system. Bankruptcy, in most cases, is the "last stop" for financially troubled individual consumer debtors. The Commission also conceded that there were abuses in the system, but did not ultimately recommend the adoption of a needs based formula or otherwise denying individuals in financial distress access to the courts.

Although bankruptcy filings have increased three-fold during the last 20 years, one cannot conclude that the reason for this increase is solely on account of debtor abuse, unwillingness of individual debtors to honor a promise to repay under a contract and the lack of social stigma associated with bankruptcy—the key factors, on which the needs based formula is erroneously premised. The Commission, bankruptcy organizations, practitioners, academicians and judges have dismissed each of these factors on the basis of the following substantial empirical data:

- The statistical evidence shows that consumers who file for bankruptcy relief today as a group are experiencing financial crises similar to families of 20 years ago.
- Most families who file bankruptcy are seeking relief from debts they have no hope of repaying. In fact, an empirical study commissioned by the American Bankruptcy Institute from Creighton University concluded that the means testing formula would only affect 3% of the Chapter 7 filers because the remaining 97% had too little income to repay even 20% of their unsecured debts over five years. The Purdue Study, funded by the credit card industry, which supported a means based test because it contended that a substantial number of debtors who file could repay their debts, has been criticized as unreliable and misleading by, among others, the Government Accounting Office. This is not the first time that the means testing has been considered—Congress has resisted this attempt over the last thirty years and should decline to endorse this proposal without the demonstration of reliable, cognizable benefits that do not otherwise burden and impair the system.
- The triggering events for filing bankruptcy by individuals depend on individual circumstances, such as layoffs, downsizing, moving from employee to independent contractor status, uninsured medical bills, car accidents, institutionalized gambling, failed businesses, job transfers, caring for elderly parents or children of siblings, divorce, etc.
- At the same time that individual consumer bankruptcies have increased, there has been an increase in available credit and massive marketing campaigns. According to the Consumer Federation of America, from 1992 through 1998, credit card mailings have increased 255%, unused credit lines have increased 250%, while debt has increased only 137%. With increased credit, the littlest financial change in a family can have devastating consequences.
- Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, concluded that a study conducted and funded by Visa, USA was "unscientific," "invalid" and "unfounded." The study had suggested that the increase in personal bankruptcies was directly attributable to the decreased social stigma of filing bankruptcy and increased advertising of legal assistance for filing bankruptcy. While the League recognizes that decreased social stigma and increased advertising are contributing factors, that is only the beginning of the analysis and does not constitute the sole bases

accountable for the tremendous increase in bankruptcies. Mr. Kowalewski concluded that the increase in bankruptcies was more a function of increased debt rather than a sudden willingness to take advantage of the system. Is it, for example, any less embarrassing for an individual to file a petition in bankruptcy than to have his home foreclosed, his car repossessed or his neighbors contacted by debt collectors?

- Requiring trustees to review each case and apply the means test and forcing debtors into Chapter 13 will overburden the system. Application of the standards and pursuit of a motion is an unreasonable burden for the panel trustees. The trustees are paid only a minimal fee (e.g., $60) for substantial responsibility in no asset cases. The means testing will involve not only analysis in each case, but also numerous motions, many of which are likely to be contested by debtors. If there are no nonexempt assets, which is generally the case in most Chapter 7 cases, how is the trustee to be compensated? Moreover, pursuing a Rule 9011 action against a debtor's attorney is not likely to produce an immediately available and certain source of recovery for the trustee. The trustee could be required ultimately to spend a potentially huge amount of time with little or no assurance of any repayment for such services. This represents a tremendous burden on the system, when according to the National Association of Bankruptcy Trustees, only one in every ten cases subject to the means testing and with apparent ability to propose a Chapter 13 plan are able to actually confirm or complete the plan.
- The establishment of the means test creates a number of anomalies. For example, if a debtor files a Chapter 13 initially, the means formula does not apply, and in a number of jurisdiction, the debtor could propose a zero percent plan and discharge the same debt he would have in a Chapter 7 proceeding. This is not what Congress intended to create under the means test.
- The means test further operates to the exclusion of the trustee's significant avoidance powers. For example, the schedules may reveal a significant preferential payment that, if recovered, would result in a distribution to creditors in excess of what they would receive upon application of the means test. Dismissal of the proceeding under such circumstances is hardly the remedy in the best interest of either the debtor or its creditors.
- The proposed means test invites manipulation by the debtor to fit within the standard. Individuals with secured debt are allowed deductions for such obligations prior to calculating available disposable net income. A debtor with too much income could trade in an old car for a new one, deduct the payment from the means formula and thereby become eligible for Chapter 7 relief. Another option is for debtors with too much income to make use of The Religious Liberty and Charitable Donation Protection Act of 1998, which allows debtors to contribute up to 15% of their gross income to charities. Such contributions are not considered in making the calculation under Section 707(b). A debtor with income of $60,000 could thereby remove $750 per month in disposable income by making the maximum allowable charitable contribution.
- If a debtor does not qualify for Chapter 7 or Chapter 13, the only alternative is Chapter 11—a costly and unfeasible alternative for most individual debtors.
- Judge Edith Holland Jones, in her Dissent to the Final Report of the Commission, has suggested that the sanctity of contract and one's moral obligation to honor promises to repay necessitates establishment of a means test, absent which bankruptcy as a social welfare program will be subsidized by creditors and the vast majority of Americans who struggle and succeed to make ends meet financially. The League is sympathetic to the issues raised by Judge Jones, however, the means test, as proposed, does not remedy the perceived abuse. Determining eligibility merely on the basis of net disposable available income, without consideration of the myriad of factors contributing to the financial problem and without court discretion, would preclude too many honest first time debtors from obtaining redress from the court of last resort.
- Congress is operating from the premise that filing bankruptcy is per se abusive. Rather, the focus of Congress should be on debtors who abuse the system by serial filings and those provisions of the Code which encourage abuse of the system (e.g., unlimited exemptions). Ultimately, the courts should be given the tools (e.g., the totality of the circumstances, including consideration of a discretionary, flexible means test) and the express authority to determine when abuse is present and how such abuse should be remedied—the concept of a fresh start and maintenance of the delicate balance between debtors' rights and creditors' remedies must be preserved. Under the current Code,

the courts do not have the authority to affirmatively look for abuse or fashion an appropriate remedy except in the most egregious circumstances. Adoption of a "totality of circumstances" test, in conjunction with a discretionary means test, would represent a major change and a vehicle by which abuse could be addressed and remedied.

IV. CONCLUSION

Maintaining and enhancing a fair, balanced and effective bankruptcy system requires consideration and debate of all the issues. Any individual change has an impact on the entire system, and cannot and must not be evaluated in a vacuum. The League takes seriously its role in this process, and believes that other options beyond the current mandatory needs based formula should be explored that would address the real abuses and preserve the bankruptcy system which Congress acknowledged it was generally satisfied with in 1994 when this process began and that the system was not in need of radical reform. Adoption of a fixed, rigid needs based formula, as contained in the Bill, represents "radical reform," which has not been justified and will impair the delicate balance inherent in the system; nor is it likely to rid the bankruptcy system of the perceived abuses.

Respectfully submitted,

JAY L. WELFORD, *Co-Chair, Legislative Committee*
JUDITH GREENSTONE MILLER, *Co-Chair, Legislative Committee.*

Mr. GEKAS. We thank Ms. Miller, and turn to Professor Zywicki for 5 minutes.

STATEMENT OF TODD ZYWICKI, PROFESSOR, GEORGE MASON UNIVERSITY SCHOOL OF LAW, ARLINGTON, VA

Mr. ZYWICKI. Thank you, Congressman Gekas. It is an honor to come before you today to testify on this historic occasion. As Congressman Gekas mentioned earlier today, it has been over 60 years since there has been a joint hearing of the House and Senate on bankruptcy, and 60 years ago we were in the midst of the Great Depression—25 percent unemployment, rampant farm failures, rampant bank failures, rampant business failures, unparalleled suffering in America, and 50,000 to 100,000 bankruptcy filings was considered a massive number, unprecedented numbers.

Today, of course, we have 5 percent unemployment, 6 percent growth rates. The farm crisis of the 1980's is past. Business bankruptcies are at an incredibly low level. And we had 1.4 million bankruptcy filings last year. We had more bankruptcy filings in the first half of 1997 than in the entire decade of the Great Depression combined.

Means testing is one of the anecdotes to this problem. Means testing can be summed up in one basic 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? That's it: Should high-income debtors, who can repay a significant portion of their debts without significant financial or other hardship, be required to do so?

Bankruptcy should be for poor unemployed, divorced people, basically down on their luck. As my co-panelist, Professor Warren, said in her great book from a while back, the generous willingness of Americans to help those in trouble is balanced by a demand that only the truly needy be helped. I think that is the attitude that we should have toward bankruptcy. Keep in mind, means testing does not interfere with high-income debtors being able to file bankruptcy. It simply says, if you file, and can repay a certain amount

of your debts, you must do so. It does not affect low-income earners at all.

Estimates are that 80 percent of people who file bankruptcy are below the national median income by this test. Eighty percent of people won't even be affected. Estimates range from, say, 3 to 5 to 10 percent—more likely, somewhere between 6 to 10 percent—of those who file bankruptcy would be affected by means testing.

But the payoff is significant. Those same studies show that 60 to 70 percent of their debts could be repaid, approximately $4 billion, if they were forced into chapter 13 rather than chapter 7. Compare that to chapter 7 rates, where 95 percent of chapter 7's make no distribution at all, and most of those who make a distribution make only a trivial distribution.

People ask me, why do you care about bankruptcy? I think the answer is that an analogy is to shoplifting. Nobody in this room is a shopkeeper; none of us own a retail store, but we are all opposed to shoplifting. Why is that? Well, first, because we all know that the losses, when some people engage in theft and shoplifting, the losses get passed onto other consumers. We subsidize those losses, at least some of them.

Secondly, it is simply unfair should get benefits that they don't have to pay for. I seem to recall a phrase a few years ago that, those who work hard and play by the rules should be protected in America. Those who work hard and play by the rules should be protected in the bankruptcy system, but those who do not should not.

Third, creditors are providing valuable goods and valuable services, whether it is goods, credit, whatever it may be. They deserve to be paid for that. We all deserve to be paid for the goods that we provide.

Finally, shoplifting and bankruptcy—shoplifting is wrong; bankruptcy is also a moral act. Bankruptcy is a moral as well as an economic act. There is a conscious decision not to keep one's promises. It is a decision not to reciprocate a benefit received, a good deed done on the promise that you will reciprocate. Promise-keeping and reciprocity are the foundation of an economy and healthy civil society.

Do we have charity? Yes. When Jean Valjean shoplifts a loaf of bread to feed his children, that is different from a rich guy who shoplifts a Rolex watch. The bankruptcy system and means testing recognize that. It protects the Jean Valjeans of the bankruptcy system, but not the fellow who is stealing the Rolex watch.

In law we have the doctrine of necessity. If you in a boat at sea and a raging storm comes up, you are allowed to tie up at the first dock that you come to. But if you are out at sea and it is a sunny day, you are not allowed to just tie up at the dock for a mere matter of convenience. The bankruptcy system should be tailored to those who have the storms of their life, but it shouldn't be the people who simply are sailing around on a sunny day and decide to cut corners and file bankruptcy for a mere matter of convenience.

Thank you.

[The prepared statement of Professor Zywicki follows:]

PREPARED STATEMENT OF TODD ZYWICKI, PROFESSOR, GEORGE MASON UNIVERSITY SCHOOL OF LAW, ARLINGTON, VA

BIO

Professor Todd J. Zywicki teaches Bankruptcy, Contracts, and Commercial Law courses at George Mason University School of Law in Arlington, VA, where he has been an Assistant Professor of Law since 1998. Prior to joining the faculty at George Mason, he was an Assistant Professor of Law at Mississippi College School of Law in Jackson, MS from 1996–1998. Prior to that, Professor Zywicki clerked for the Honorable Judge Jerry E. Smith on the United States Court of Appeals for the Fifth Circuit, and practiced bankruptcy law with Alston & Bird in Atlanta, GA. He received his J.D. from the University of Virginia in 1993, a Master's Degree in Economics from Clemson University in 1990, and his undergraduate degree cum laude with distinction in his major from Dartmouth College in 1988. Professor Zywicki is the author of over 20 published articles, essays, and book reviews in both law reviews and economics journals. He has written widely in the areas of bankruptcy, environmental law, constitutional law, constitutional history, and economic analysis of law. Professor Zywicki is also a Contributing Editor to the *Norton Bankruptcy Treatise* and Co-Chair of the Bankruptcy Subcommittee of the Federalist Society's Financial Institutions Practice Group. He has previously testified on bankruptcy issues before the United States Senate, Judiciary Committee, Subcommittee on Administrative Oversight and the Courts. Recent publications on bankruptcy law include, "It's Time for Means-Testing" (co-authored with Judge Edith H. Jones), 1999 *BYU L. Rev.* (forthcoming 1999); "Rewrite the Bankruptcy Laws, Not the Scriptures: Protecting a Bankruptcy Debtor's Right to Tithe," 1998 *Wisconsin L. Rev.* 1223; "Mend It, Don't End It: The Case for Retaining the Disinterestedness Requirement for Debtor in Possession's Professionals," 18 *Mississippi College L. Rev.* 291 (1998).

STATEMENT

Distinguished Senators and Representatives, it is a distinct honor to testify before you today on the subject of consumer bankruptcy reform. I have practiced, taught, and published articles on the subject of consumer bankruptcy. Most recently I am a co-author with Judge Edith H. Jones of the forthcoming article, "It's Time for Means-Testing," which will be published in the B.Y.U. Law Review, a copy of which Judge Jones and I have inserted into the record, and the author of a working paper on "Credit Cards in Bankruptcy."

The debate over means-testing boils down to a 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? To this question, I believe the answer must be "yes."

Bankruptcy has traditionally been intended as a last resort for those who are poor, unemployed, suffering from health problems, or otherwise down on their luck. Bankruptcy should not be a first resort for those who simply and consciously choose not to live within 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, it will protect the poor and unfortunate debtors for whom bankruptcy is intended.

Opponents of means-testing have engaged in a high degree of hyperbolic rhetoric designed to obscure the central issue of whether high-income debtors should be required to repay their debts if they can. But an inspection of the goals and practical effect of means-testing shows these concerns to be without merit. Means-testing does exactly what its name suggests; it requires those who have the "means" to repay their debts to do so. By definition, means-testing does not apply at all to the great bulk of bankruptcy filers, the roughly 80% of Chapter 7 filers whose incomes are below the median national income. Studies repeatedly indicate that means-testing would affect a maximum of 10% of all bankruptcy filers, all of whom, by definition, earn incomes that exceed the median national income, adjusted for family size.

Although means-testing would cover a relatively modest number of bankruptcy filers, its financial impact would be substantial. It targets an extremely well-defined group of bankruptcy filers who could pay all or substantially all of their outstanding debt with minimal hardship. Studies repeatedly conclude that those affected by means-testing could pay approximately 60%–70% of their unsecured debts if they filed under Chapter 13, which amounts to a total of over $4 billion. By contrast, 95% of Chapter 7 bankruptcy filings make no distribution at all to unsecured creditors, and those that do rarely pay out more than a trivial amount. Despite the much larg-

er payout made to creditors in a Chapter 13, debtors usually are advantaged by filing under Chapter 7. As a result, 72% of individual cases are filed under Chapter 7. More detailed summaries of the findings of the relevant studies and the mechanics of how means-testing would work in practice are provided in the article authored by Judge Jones and myself. But one thing is clear, even though the reach of means-testing is small in terms of the number of filers impacted, its impact would be large in terms of the amount of money collected. Moreover, it is likely that the economic and other benefits of means-testing, such as uniformity, fairness, and confidence in the operation of the bankruptcy system, would more than offset any increases in administrative costs—if any—that might result from its adoption.

Consider, for instance, the recent case of Dr. Robert N. Kornfield. *See In re Kornfield*, 164 F.3d 778 (2d Cir. 1999). Dr. Kornfield is a gastroenterologist in New York who earned $472,445 in 1994, and $404,593 in 1995, before his income "plummeted" to a "mere" $276,000 in 1996. He had an additional amount of $390,216 in pension or profit-sharing plans. As for debt, he had $508,664.85 in two mortgages, and additional debt of $76,029.15. He also was spending $53,640 per year in private schools for his children, despite a specific finding by the bankruptcy court that appropriate public schools were available for educating Dr. Kornfield's children. In sum, the bankruptcy court "found that the debtors had incurred substantial debts largely because of an extravagant lifestyle that they declined to alter in the face of lowered income," *Kornfield*, 164 F.3d at 783, and the Second Circuit concluded that the debtor was "enjoying a substantial income but seeking to transfer the cost of an unnecessarily extravagant lifestyle to creditors," *id.* at 784.

Is Dr. Kornfield representative of the vast bulk of individual debtors in the bankruptcy system? No, he is not. But is he representative of a certain class of debtors in the bankruptcy system—those who file bankruptcy not as the result of financial hardship as conventionally understood, but merely as a convenience to maintain "an unnecessarily extravagant lifestyle" and to transfer the cost to creditors? Yes, he is. And this class of opportunistic debtors grows larger every day. In the end, Dr. Kornfield's Chapter 7 case was dismissed for "substantial abuse" under δ707(b), but his case provides an illustration of the problems with the current regime for policing opportunistic debtors such as Dr. Kornfield and why means-testing is a necessary antidote.

Before Dr. Kornfield's case was finally resolved, he had contested the issue in the bankruptcy court, district court, and all the way to the court of appeals. At that point the Second Circuit adopted a "totality of circumstances" test to determine whether a particular case should be dismissed for "substantial abuse." Under this approach, in every case the court will be required to consider all of the factors that might be relevant as to whether a case should be dismissed for "substantial abuse," of which ability to pay is perhaps the most important factor, but not the only factor for the court to consider. The adoption of a "totality of circumstances" test means that in every case where dismissal is sought under δ707(b), courts will have to engage in detailed fact-finding and sifting and weighing of evidence with little guidance as to the proper legal standard to apply. As a result, the outcome in any given case will be highly dependent on the judge's inclinations and the debtor's ability to find and fund talented counsel. Moreover, the case was dismissed, but only after a lengthy and expensive process that involved an initial hearing, followed by two layers of appeals. Thus, the lack of clear rule of decision spawns delay, expensive hearings, and repeated appeals that impose a significant financial cost on the bankruptcy system and the court system generally.

Dr. Kornfield's case also illustrates the unfairness and non-uniformity of results under the current system. Egregious cases pass by unnoticed every day in bankruptcy courtrooms throughout America. Dr. Kornfield had the misfortune to draw a particular U.S. Trustee and particular Bankruptcy Judge who would not let his case pass without objection. Similarly-situated debtors who file in other districts or even those who file in front of other judges in the same district may receive very different treatment. Given the rule-less inquiry established by the current law, the outcome in any given case is quite unpredictable and may be expensive to litigate. This phenomenon of similarly-situated debtors receiving disparate treatment has created both a reality and a perception of unfairness and non-uniformity.

Finally, Dr. Kornfield's case reflects a disturbing trend in modern bankruptcy law—the seemingly cavalier attitude of some towards filing bankruptcy and repudiating one's debts. As the bankruptcy court noted, Dr. Kornfield's bankruptcy resulted from a conscious decision to try to maintain his "extravagant lifestyle" in the face of lowered income. Rather than moving into a more modest house or sending some of his children to public school, he chose to file bankruptcy and force his creditors to subsidize his decisions. Dr. Kornfield hardly fits the image of the poor and/

or unfortunate debtor looking for a fresh start to get back on his feet. Instead of tightening his belt, he filed bankruptcy and repudiated his obligations.

Means-testing will mitigate many of the problems illustrated by Dr. Kornfield's case. By establishing a clear, bright-line rule for Chapter 7 eligibility, means-testing will reduce the high administrative costs associated with the current system. Debtors and creditors will know with a very high degree of predictability whether the debtor will be eligible for Chapter 7. As a result, there will be less uncertainty involved in the decision whether to bring an action or for a debtor to contest an action. Eligibility challenges will be limited to an extremely small set of cases. Most cases will either plainly qualify under the test or not qualify, and there will be only a small number of cases where the debtor's eligibility under the ability-to-pay test will be in doubt. Under the current approach, by contrast, there is little predictability or justice in who might be the subject of a challenge. Extremely high-income debtors will often avoid eligibility challenges, while many debtors of relatively modest means will suffer challenges. Moreover, means-testing will ensure that those who can repay all or substantially all of their debts under Chapter 13 will be required to do so, thereby eliminating the incentive to file bankruptcy and encouraging those debtors to work out voluntary repayment arrangements. Thus, these cases will not even be filed in the first place, eliminating the administrative costs of dealing with them. Moreover, as illustrated by Dr. Kornfield's case, many of these cases will be those with high administrative costs, with multiple and complex evidentiary hearings and appeals, thus the savings on these cases will be substantial.

Means-testing will also provide much-needed guidance to courts and trustees seeking to prevent abuse of the bankruptcy process. Rather than a free-ranging "totality of circumstances" test and the cost and uncertainty associated with interpreting and applying it, means-testing will channel the court's discretion into a much more narrow and predictable range of inquiry, thereby limiting strategic challenges by both creditors and debtors. Forcing all judges to focus on the same factors and weigh them consistently, will also make decisions more predictable and uniform. This will increase public confidence in the bankruptcy system by reducing the real and perceived unfairness associated with the current regime where who gets caught and who does not appears to be mere happenstance.

Finally, means-testing will have non-quantifiable intangible benefits associated with reasserting the moral premise that people should be required to repay their debts to the extent that they can, especially if doing so would impose minimal hardship on them and their standard of living. This, moral signal must be weighed as one of the benefits of means-testing.

Although an extreme example, Dr. Kornfield's case is all too typical of the modern bankruptcy system. Bankruptcy filings have exploded in recent years, despite low unemployment and robust economic growth. There are two explanations for this surge in filing rates: a change in the relative economic costs and benefits of filing bankruptcy, and a decline in the personal shame and social stigma traditionally associated with filing bankruptcy. See generally Edith H. Jones and Todd J. Zywicki, "It's Time for Means-Testing," 1999 BYU L. Rev. (forthcoming).

Beginning most noticeably with the liberalization of bankruptcy laws ushered in with the 1978 Code, there has been a predictable upward trend in bankruptcy filing rates. The 1978 Code significantly reduced the economic costs and increased the economic benefits of filing bankruptcy. Indeed, economist Michelle White estimates that 15%–20% of American households would financially benefit from filing bankruptcy, especially if they engaged in some planning prior to filing.

This increase in the financial benefits of filing bankruptcy has been accompanied by an offsetting decrease in the associated costs. In particular, there has been a substantial reduction in the "search costs" associated with learning about bankruptcy. The spread of attorney advertising in the 1980s made it easier to inform individuals about the availability of bankruptcy as a financial planning tool. Daytime and late-night television, as well as newspapers, magazines, and telephone books, are now awash in bankruptcy advertisements by lawyers. Equally important is the "water cooler" effect: a huge number of people learn about bankruptcy from friends and family who have been through the process and report that it was cheap, easy, and put an end to creditors' collection efforts.

As performer Toni Braxton memorably told a reporter after filing bankruptcy in 1998, "I'm going to go out and enjoy myself." At the time of her bankruptcy, Braxton's albums had earned $170 million in sales and she owned a baby grand piano, a Porshe, and a Lexus. Most private companies have to pay celebrities large sums of money to endorse their products in advertisements; the ease with which Braxton, Kim Basinger, Burt Reynolds, John Connolly, M.C. Hammer, and others have sailed through bankruptcy is equivalent to free advertising for the bankruptcy system. Nor is Braxton's attitude limited to the very well-to-do. Consider the senti-

ment expressed by a middle-class filer from New York who used the bankruptcy system to maintain their unrealistic standard of living, "We're not doing the pauper thing. . . . We have a nice house. We go to Foxwoods. We have his and her cars. It took us a long time to go from Brooklyn to Queens. We can't go back." Finally, the sheer volume of bankruptcy cases has spawned a cottage industry in "do-it-yourself" bankruptcy kits and so-called bankruptcy "mills" that represent debtors in high-volume, repetitive cases. These too have further reduced the costs associated with learning about and filing bankruptcy.

There has also been a reduction in the shame and stigma associated with filing bankruptcy. Bankruptcy represents a repudiation of one's promises, a decision not to pay someone back for a benefit that they have bestowed upon you. This ethic of reciprocity and promise-keeping is the foundation of a free economy and a healthy civil society. We teach our children from a very young age to keep their promises and to reciprocate benefits bestowed upon them. We also internalize these lessons through our consciences and often feel personal shame when we fail to keep our promises; when we take without giving back. As a result, filing bankruptcy traditionally has been treated as a socially and personally shameful act. Part of Harry Truman's lore was his decision to voluntarily repay the debts of his failed haberdashery. It took him 15 years to do so, but in the end he did and was applauded for it.

But this ethic of paying one's promises now seems old fashioned and out of vogue. In short, there are too many Robert Kornfields and too few Harry Trumans on the current bankruptcy landscape. To paraphrase Senator Moynihan, we have "defined bankruptcy deviancy downward" to the point where many see it as simply an alternative financial planning device. Moreover, because the financial benefits of filing bankruptcy are greatest for upper-income debtors, the role of personal shame and social stigma has had its greatest marginal impact in restraining those individuals from filing bankruptcy opportunistically. The underlying dynamics driving the surge in personal bankruptcies predicts an ever-growing influx of high-income debtors into the bankruptcy system in coming years and thereby reinforces the urgency of means-testing.

Who are the beneficiaries of means-testing? We all are. To see why, consider that although few of us actually own retail shopping stores, all of us oppose shoplifting and believe that it should be forbidden. The reasons why we support laws against shoplifting are analogous to the justifications for means-testing. First, when people shoplift or don't pay their bills, we all suffer in the form of higher prices for goods and for credit, as at least some of those losses are necessarily passed on to us as fellow consumers. Second, allowing some people to obtain goods, services, or credit without paying for it is simply unfair to those who do act responsibly and pay for the benefits they receive. Third, retail sellers and those who extend credit are selling a useful product or providing a socially-beneficial service for which they are entitled to be paid. We all have to work for a living and we are all entitled to be paid for the goods and services that we provide. Finally, shoplifting simply is wrong; it violates trust and it breaks promises. You shouldn't take it if you aren't going to pay for it. Just as one need not be a shopkeeper to be opposed to shoplifting, one similarly need not be a banker to be in favor of means-testing.

Rather than facing up to the existence of abuse in the bankruptcy system by some unscrupulous high-income debtors, critics of means-testing have chosen to point fingers at creditors for causing bankruptcy, with credit card issuers identified as the primary villains. As an explanation for the massive rise in bankruptcy filing rates in recent years, this "blame the creditors" mentality has tremendous popular appeal. But it also has little credibility as an explanation for spiraling bankruptcy filing rates.

Several commentators have argued that increases in overall consumer debt and debt-to-income ratios explain the recent surge in bankruptcy filing rates. There are several problems with this thesis. First, it incorrectly treats debt levels as an exogenous variable, unaffected by the relative ability of borrowers to discharge those debts in bankruptcy. But a borrower's willingness to take on debt clearly will be related to the ease with which he can later discharge those debt obligations if he chooses to do so. Hence, debt levels are an endogenous variable as well, and will be a function of the overall bankruptcy system. Second, those who have postulated a link between debt and bankruptcy have failed to provide a persuasive explanation as to how debt could "cause" bankruptcy for individuals, as opposed to businesses. Significantly more important would be the relationship between *current* debt—the amount that a debtor is required to pay each month—and bankruptcy. Individual bankruptcy would seem to be the result of an inability to meet one's obligations as they come due, not insolvency in some type of balance-sheet accounting. Because of the extremely low interest rates of recent years, current debt levels have fallen even

as overall debt levels have risen. As a result of these low interest rates, borrowers should be able to carry the same or even marginally greater debt levels at greater ease than before, thereby contradicting the "debt causes bankruptcy" thesis. Third, debt does not exist in a vacuum, it accumulates through the decisions of consumers to purchase goods and services. Thus, "too much debt" in many cases could simply be recharacterized as "too much spending," as was the case with Dr. Kornfield. It is not debt that causes bankruptcy for many people, it is a conscious choice not to live within one's means and to finance an extravagant lifestyle through borrowing rather than belt-tightening. Finally, statistics on debt simply do not provide an explanation for the rapid run-up in bankruptcy filing rates of recent years. As one commentator has observed, even if debt-to-income ratios have worsened, they have done so 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."

Nor will it do to blame credit card issuers. Because of their visibility, credit card issuers have become easy villains for those seeking to blame creditors. As Judge Jones and I wrote, "[C]redit card issuers have become the modern equivalent to William Jennings Bryan's 'Cross of Gold,' crucifying consumers in the pursuit of ever-greater profits." But blaming credit card issuers for the bankruptcy boom is implausible on its face. First, the total credit card debt burden of $529 billion pales in comparison to overall housing debt of $4 *trillion*, and housing debt has been increasing much faster than revolving debt in recent years. Second, most Americans are "convenience" users of credit cards who pay off their balances each month and therefore accrue no interest fees or service charges. Focusing on those who revolve balances from month-to-month ignores the reality that few Americans fit this profile.

Those who would vilify credit card issuers also misunderstand the role that they play in the modern American economy. Entire segments of our economy, such as internet and catalogue shopping, would not exist without consumer access to credit cards. Credit cards enable individuals to deal with short-term emergencies like car and home repairs, without having to hoard large amounts of cash in non-interest bearing checking accounts, not to mention all the fringe benefits of frequent flyer miles, rental car insurance, purchase price protection, and even cash back bonuses. Moreover, the credit card industry has revealed itself to be ferociously competitive. In a market with 6,000 issuers and millions of consumers it is hard to imagine it being otherwise. And, indeed, after an early period of high profitability following deregulation, profits on credit card issuers have decreased substantially in recent years.

Access to credit cards are especially important for low-income borrowers, as they lack the options of more wealthy borrowers. For instance, low-income borrowers obviously will have less access to home equity loans than the rich. Absent credit cards, low-income borrowers faced with a short-term need for cash, such as the need for a new transmission for a car, will face an array of unfavorable options: selling personal assets, taking them to a pawn shop, or trying to get a short term loan from a bank that will probably charge them fees and an interest rate that substantially exceed that available on credit cards. Dagobert Brito and Peter Hartley, economists at Rice University, observe that there are few substitutes for the low transaction cost access to short-term credit offered by credit cards. As a result, despite the seemingly high rates of interest charged by credit cards, it is actually quite rational for many people to revolve balances on credit cards. *See* Dagobert L. Brito & Peter R. Hartley, "Consumer Rationality and Credit Cards," 103 *J. Pol. Econ.* 400 (1995). Access to credit cards have democratized credit, making its advantages available to all when it previously was available only to the elite.

Means-testing is an idea whose time has come. Courts are already applying a variation of means-testing, but with highly unpredictable and unfair results. 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.

Mr. GEKAS. I thank the witness and turn to our final panelist, Professor Warren, for 5 minutes.

STATEMENT OF ELIZABETH WARREN, LEO GOTTLIEB PROFESSOR OF LAW, HARVARD LAW SCHOOL, BOSTON, MA

Ms. WARREN. Thank you, Chairman Gekas. I also say, as others have, it is an honor to be here, and particularly a an honor to be here at your personal invitation.

I will start as Judge Kenner did. She caused me to do a calculation, and that is, I have now been teaching bankruptcy and business law for 20 years, and I think that means that I have now seen the coming of age of about 4,600 lawyers, a much scarier concept, isn't it?

I thought I would start today by talking just a little bit about who is in the bankruptcy system. We have heard from creditors; we have heard from judges; we have heard from academics. The people we haven't heard from are the debtors, the people who are affected by this system. I just want to give a sketch of a few things that we know about these people.

We know that two out of every three debtors who file for bankruptcy have suffered a significant period of unemployment or job interruption in the 2 years before they have filed. These are people who have been downsized, outsized into jobs or into smaller jobs, lesser jobs, unemployment, independent contractor status that carries no benefit and many weeks carries no income.

We know about divorce. We know that the people who file for divorce are more likely also to file for bankruptcy. If I know nothing more about the women in this room other than the fact that their current marital status is that they are divorced, I know that they have a 300 percent greater likelihood of being in bankruptcy this year alone than their cohorts who are single or who are married.

Medical debts. About one in five of the debtors who file for bankruptcy identify themselves as having significant medical debts before they filed for bankruptcy and identify this as the source of their problems. Lack of insurance is felt in the bankruptcy courts. This is the only place to deal with it.

Homeowners some of the most trying stories in bankruptcy. About half of the people who file for bankruptcy are homeowning folks, people who have passed the most rigorous credit standards at some point in their life. And why are they in bankruptcy? They are in bankruptcy because they are trying to save their homes. What we know about these people, particularly, is that they are the most fragile homeowners. African-American homeowners and Hispanic-American homeowners have a much increased percentage of bankruptcy relative to white homeowners. These are people who have suffered from discrimination both in housing and in the workplace, and those forms of discrimination make their way into the bankruptcy courts.

We know that the elderly are also in bankruptcy. About 280,000 people filed for bankruptcy last year who are older than 50. We know that about 50,000 of the filers are older than 65. What is one of the principal reasons that they file for bankruptcy? They file for bankruptcy because they are disproportionately the victims of the scams in the credit industry. They file to try to deal with aggressive creditors. They say, quite simply, they can't cope with the phone calls anymore; they can't cope with the people visiting them. These are people who use bankruptcy as a way to stop abusive collection practices.

Small business owners. Those are also among the people we haven't heard about today. One in five Americans who files for bankruptcy is a failed entrepreneur. If you start your own business you have a three times greater likelihood of ending up in bank-

ruptcy court than anybody else in America. Entrepreneurs are about 7 percent of our population, but they are 20 percent of those who are in bankruptcy. Why are they in bankruptcy? They are in bankruptcy because little businesses are fragile, and they have had to guarantee personally all of the debts. Even if they are not trying to keep their businesses afloat, if they have given up on the notion that they can keep the store open or keep working as an independent person, the idea of going back to a wage-earning job no longer works for them because they are $50,000, $75,000, $100,000 in debt from their failed businesses.

These are the people who are not represented in this room today, but we have to think about when we think about bankruptcy reform.

What does this bill do? This bill is more than 300 pages long. The consumer provisions go on for a long, long time—and I say that as an academic who is used to reading lots and lots of statutes.

I want to make a global point. This debate isn't about means testing or at least not means testing alone. That has been a flash point. That has been the lightning rod, and it is important to hear. But this is about a thousand traps that have been set for debtors in this bill. Means testing is there to push debtors out of chapter 7.

Increasing nondischargeability of credit card debts claps them on the other side. It says, you went through bankruptcy, but you didn't get much help from it, because many of your creditors will still be there on the other side.

Reducing eligibility for chapter 13 means these people can't move from chapter 7 over to chapter 13 to repay. It just means they move back out of the system, so that their creditors can pick them apart however they want.

Allowing creditors' motions under 707(b) means that creditors who have much more money and much more leverage can just squeeze debtors harder. That is the key point.

What is this bill about? This isn't about whether or not we get a few people to pay more. It is whether or not we can squeeze people to pay outside bankruptcy, often by signing more reaffirmations. This is where the major scandal in this system is. What this bill does is it lets the creditors increase the size of their club, at the same time that it says you can as many reaffirmations as you want. There is no effective control over reaffirmation.

Let me make this clear: The Sears case, under this bill, could no longer be brought. Any attempt of debtors to get together and bring a class action for any of the abuses of the system would be gone.

I would like to close, if I could, by just reading from one debtor in the Sears litigation. She says about her Sears reaffirmation, "I truthfully wasn't paying attention when the Sears lady asked me for the reaffirmation because I was crying and so upset that I had failed to be able to pay my debts in the first place. Otherwise, I wouldn't be in a bankruptcy court. Well, I worked two full-time jobs for almost 7 years after my divorce with my seven children. The two full-time jobs affected my health, and I couldn't work them anymore. That is when I stopped paying Sears $150 a month."

She goes on to say that she lost her home. Let me make it clear: This was a legal reaffirmation. This one was denied under the Sears settlement.

[The prepared statement of Professor Warren follows:]

PREPARED STATEMENT OF ELIZABETH WARREN, LEO GOTTLIEB PROFESSOR OF LAW, HARVARD LAW SCHOOL, BOSTON, MA

THE NEED FOR REFORM

All legal systems benefit from periodic adjustment to account for changed circumstances, to address unforeseen consequences, and to reconcile divergent court interpretations. The bankruptcy system is no different. For one hundred years, Congress has periodically adjusted the Bankruptcy Code to reflect these kinds of adjustments. This is a healthy process that helps insure efficiency, effectiveness and, most importantly, public confidence in the system.

No one doubts that the bankruptcy system could be improved by amending the Bankruptcy Code to address identified and documented ambiguities and problems. But any reform must be balanced. The bankruptcy community—judges, lawyers, accountants, academics, trustees, and others—has been engaged in a continuing dialogue.

I favor reform. But not all change is reform.

The key to bankruptcy reform, like other types of real reform, is to make changes in a narrowly targeted and carefully crafted fashion so that the cost of these changes does not outweigh the anticipated benefit for parties in these cases and for the public at large.

A good example of the failure of the cost-benefit analysis is evident in the proposed means test. The credit industry for forty years has pressed for a means test of the kind proposed in H.R. 833. Twenty years ago, they claimed that without means testing consumer credit would dry up. They claim today that without these reforms bankruptcy costs every American family $550. The accuracy of that statement has been challenged by research supported by the American Bankruptcy Institute, an independent organization of professionals representing both debtors and creditors. That research, conducted by Professors Marianne Culhane and Michaela White, suggests that the means test in H.R. 833 would produce very little benefit. If even the most optimistic estimates of the debtors' capacity to repay come true (what Culhane and White deem "the impossible dream") and even if many of the administrative costs of implementing and enforcing a means test were ignored, the independent study shows that the proposed change would increase recoveries for creditors by a total of about 90 cents each year for each household.[1] This is not narrowly tailored, cost-effective reform.

When dealing with the bankruptcy system, it is especially important to take a careful cost-benefit approach. Bankruptcy is a collective proceeding involving a limited pool of resources. If the law gives more benefits to one creditor, other creditors suffer. Bankruptcy is the ultimate zero-sum system. Creditors compete for the limited dollars of the people who have declared themselves bankrupt. More to one creditor is necessarily less for another.

Who are these creditors? Creditors are not just car lenders, credit unions, and credit card companies—the people we hear from today. Some creditors are women and children collecting support. In addition, they are utilities, landlords, doctors, hairdressers, plumbers, the paper girl, neighbors, federal state and local taxing authorities, and many others. These creditors have interests that, by definition, are adverse to each other—not just to the debtor. More money for retailers issuers means less money for car lenders; more money for banks is less money for landlords; more money for credit card issuers is less money for mothers collecting child support. And more money for administrative costs means less money for everyone. Bankruptcy does not create money; it creates only collection priorities among creditors for the very limited dollars of the debtors.

H.R. 833 IS NOT REFORM

Almost every day, someone asks me about this bill. And, almost every day, I respond that I am deeply, deeply concerned about this bill.

[1] Marianne B. Culhane and Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, American Bankruptcy Law Review (forthcoming 1999).

Am I concerned because I oppose reform?

Am I concerned because I think that some people should get a free ride at the expense of everyone else because I do not care whether I pay a hidden bankruptcy tax?

Am I concerned because I do not care if people exercise personal responsibility?

Of course, the answer to all of these questions is no, a loud and resounding no.

Then why does this bill worry me so much? Because change does not equal reform. The definition of reform is "to improve by correction of error or removal of defects." A secondary meaning is "to abolish abuse." This bill does neither.

Instead, the bill will cause chaos. It is loaded with complicated and conflicting policy choices added to try to satisfy competing special interests. It is rife with sloppy technical work that will create ambiguities to be litigated for twenty years or more.

Moreover, the bill is one-sided. It has more than 120 pages of amendments affecting consumer cases, and they all head in the same direction: They give a few creditor interests more opportunities to try to recover from their debtors while they reduce the protection for other creditors and for debtors. Although the bill contains a few provisions bearing labels that suggest they provide needed protections for consumer or address creditor abuse, a careful reading of those provisions reveals that they will do little in practice.

Among the most objectionable features of the current proposals are:

The failure to introduce real reform for debtor abuses by limiting property exemptions

Provisions to increase the number of nondischargeable debts for *every* family in bankruptcy, including the very poorest

Changes that will permit fewer debtors to qualify for repayment plans, thereby reducing—not increasing—the number of Chapter 13s

Conflicts among provisions that push debtors out of Chapter 7 (means testing) but restrict access to Chapter 13 (increasing payments to secured creditors required to confirm a plan)

A means tests that is impossible to administer, that will swamp the bankruptcy courts, and that invites creditors to use their superior resources to leverage debtors into making improvident repayment agreements

No review of reaffirmation agreements despite the scandals in the bankruptcy courts in the last two years

Let me be clear. Although I believe that this bill can be improved from its current state, I fear that it is flawed to its core. It is flawed because its underlying structure is not designed to stop abuse or to increase personal responsibility. Whatever the intent of the drafters, the bill will make the system dysfunctional. This is why bankruptcy professionals in organized groups (such as the National Bankruptcy Conference), on their own (such as the bankruptcy judges and the bankruptcy law professors), and as representatives of responsible creditors (such as the Commercial Law League) have opposed this approach to reform.

As lawmakers, you are entitled to make the policy decision to shut down the bankruptcy system. If this is your goal, however, it would be more efficient to simply repeal parts or all of Title 11.

ELEMENTS OF REAL BANKRUPTCY REFORM

Real reform is within your reach. Among the provisions that would improve the system for everyone—both debtors and creditors—are:

Restrict repeat filings

Limit property exemptions that are too high

Deny bankruptcy distributions to creditors who do not play by the rules, particularly creditors who violate rules on predatory lending practices

Implement systematic audits in combination with data collection, making it possible to develop a more accurate picture of what is happening in the system

Reduce creditor overreaching by restricting access to reaffirmations

Improve credit disclosures so that borrowers can know their actual balances, amortization rates, and effective interest rates

Require that advertisements and applications for home equity loans and lines of credit disclose limits on the tax deductibility of such loans

Restrict the use of teaser rates, hidden fees, shortened payment periods, and other practices that are designed to take advantage of unsuspecting consumers

Give courts wider latitude to dismiss Chapter 7 cases for debtors who do not need bankruptcy relief, while avoiding arbitrary guidelines that are easy for abusers to evade

WHY DO ALL THIS WORK?

Meaningful bankruptcy reform is a lot of work. Twenty-six disparate groups ranging from the Family Law Section of the American Bar Association to the Leadership Conference on Civil Rights to Mothers Against Drunk Driving have told you that this bill is not a good approach and that it is in fact counter-productive.

The effort is worthwhile. The people who rely on this system are the people who are not here today.

They are the owners of small businesses who struggle to get back on their feet after their businesses have failed

They are divorced women trying to raise families and stabilize their financial lives

They are elderly Americans who are disproportionately victims of creditor scams and fraud

They are families in which one or both parents have lost a job or been downsized or outsourced into a job that pays less and provides fewer benefits

They are African American and Hispanic American homeowners who, facing every form of housing, mortgage and insurance discrimination, are making a last ditch effort to hang on to their homes

They are students, beginning their adult lives already so deeply in debt with credit cards that they will never be able to buy a home or support a family

They are families without insurance and families with too little insurance for the medical catastrophes that have come their way

These people don't see themselves as debtors. They see themselves for what they are: nurses and construction workers, factory workers and shopkeepers, retired people and college students, teachers and cabinetmakers. They could be anyone in this room.

The people who rely on this system are the people who live in your districts. On average, about one out of every 72 of the households in your districts will file for bankruptcy *this year*. Since 1994, about one in 20 of the households in your hometowns has declared bankruptcy.[2] These are your constituents. They vote, use our public schools and libraries, go to our churches or other religious services, pay taxes. Most of them, as even the most aggressive proponents of the bill have conceded, find themselves in bankruptcy due to a catastrophic event that they could not weather. Some are profligate; most are not. All of them are overwhelmed by debt.

Bankruptcy law is the last safety net of the middle class. A change that unbalances the system is not reform—it is wholesale revision that substitutes complex special interest legislation for a carefully balanced system that has worked for more than a hundred years. Bankruptcy is the last hope for the small businessman, the divorced woman, the African-American homeowner, the displaced executive, and the elderly couple facing a sharp slide out of the middle class into the lower class. It is a system worth saving.

Mr. GEKAS. Well, we thank Professor Warren.

The Chair will allot itself 5 minutes for questions and answers.

Professor Warren, reaffirmation is possible under current law, isn't that correct?

Ms. WARREN. Yes.

Mr. GEKAS. And so the evils that you attach to reaffirmation are not made worse by the provisions that we have in our bill, espe-

[2] Calculated from data provided by the Administrative Office of the United States Courts, March 1, 1999.

cially since they try to follow the Sears case guidelines. Don't you agree?

Ms. WARREN. No, Congressman, I don't. What you are doing with this bill is at every turn you are increasing the leverage of creditors to secure reaffirmations from debtors than you are doing——

Mr. GEKAS. What leverage do they now have in reaffirmation?

Ms. WARREN. I'm sorry?

Mr. GEKAS. What leverage do they now have in reaffirmation?

Ms. WARREN. They can threaten to bring lawsuits.

Mr. GEKAS. I'm saying, under the current law.

Ms. WARREN. They can threaten to bring lawsuits. They can say——

Mr. GEKAS. So reaffirmation under the current law is a tool of the creditors, you are saying?

Ms. WARREN. Yes, and you are increasing the power of that tool by giving them more reaffirmation—more nondischargeability provisions, by giving them the ability to bring an action under 707(b), and by cutting off their access to chapter 13, where they could deal with their debts in a repayment plan.

Mr. GEKAS. You mean separate from reaffirmation?

Ms. WARREN. That is right. All the other things——

Mr. GEKAS. What I am saying to you is that reaffirmation in our bill is not that distant from reaffirmation under the current law. If you can consider it as an evil tool of creditors to crush the debtor, it exists now, and what reform measures do you have for reaffirmation as of now?

Ms. WARREN. I believe that what we should do is we should restrict reaffirmation. If what we are going to try to do is find that 3 percent that——

Mr. GEKAS. Until this reform measure came up, had you offered——

Ms. WARREN. Yes, sir, I have.

Mr. GEKAS. To whom?

Ms. WARREN. To the National Bankruptcy Review Commission.

Mr. GEKAS. Did they adopt those?

Ms. WARREN. I am trying to remember. There were so many provisions——

Mr. GEKAS. I think not. I think not. But the point is, that is just one set of problems.

Another set: You state in your written statement, and you made mention of it in your oral statement, that the people who are the debtors, the ones who are not witnessed here, I believe that we are taking into account their plight by setting the median income as a test pattern that puts most of them in full fresh-start status in chapter 7. We believe that. You may disagree with that, but the very litany of groups of people that you talk about we protect. African-Americans and Hispanic-American homeowners we protect if they need protection. Students, families without insurance and families with too little insurance, all the catastrophes that you outline in your written statement, and which you reiterate in your oral statement, are protected in our bill. Do you dispute that?

Ms. WARREN. Yes, Congressman, I dispute it, and I dispute it vigorously.

Mr. GEKAS. Well, then we will have to continue the dispute and see——

Ms. WARREN. Well, would you like me to say why?

Mr. GEKAS [continuing]. Who can foster——

Ms. WARREN. Do you want me to say why?

Mr. GEKAS. Yes, of course.

Ms. WARREN. Good. I dispute it because the nondischargeability provisions have no income floor. They will apply to people who make $10,000. They will apply to people who make $8,000 a year. They will apply to everyone. There is no income floor on that.

Mr. GEKAS. What is the nondischargeability status today?

Ms. WARREN. There is some nondischargeability. You are increasing it, and you are making it worse for various debtors——

Mr. GEKAS. Even without our reform?

Ms. WARREN. If you are asking me, is the system bad today, I would say, yes, I think there are some tough parts in the system, but you are making it much worse.

Mr. GEKAS. It is bad, you are saying, the system today?

Ms. WARREN. Some parts of it. Yes, I think there are some of the nondischargeability provisions today that make no sense. But you are not making it better; you are making it worse; you are adding to them.

Mr. GEKAS. In a large sense, the criticisms that you visit against our reform measure exist in your criticism of the current system?

Ms. WARREN. No, Congressman. What I am saying is, you are taking a system that has balanced the power between debtor and creditor. Is it perfect at every point? No. I think there are some places where creditors have the advantage; I think there are some places where debtors have the advantage. And what you are doing, Congressman, is that you are adding 300 pages of provisions that do nothing but add leverage to the hands of the creditors.

Mr. GEKAS. Judge Jones, you mention in your Law Review article, and Professor Zywicki, that the critics of the means test, for instance, seem to put the blame on the credit card issuers, no matter what the cause of bankruptcy is. What do you say to that?

Ms. JONES. Well, I think we demonstrated that the conventional wisdom in the bankruptcy community, which is precisely that argument against credit card issuers, is not just well-founded, for a number of reasons. A couple of them were stated by the MBNA fellow earlier here. But among those are we have seen a sea change in the way in which credit cards are used by the American people, and the terms and conditions of those credit cards—he referred to competition; that the card industry has gotten so much more competitive, that interest rates are going down; fees are being waived; a lot of other benefits are being given to customers. Most customers roll over their accounts every 30 days. Most customers never even incur a finance charge. So that whole argument is a house of cards and a red herring.

May I make an observation about Professor Warren's comments on reaffirmation?

Mr. GEKAS. Yes, without objection.

Ms. JONES. I was on the Commission. Professor Warren was the advisor to the Commission. I wrote 250 pages of dissents to the Commission report. Precisely what the Commission, the five-mem-

ber majority recommended was essentially to do away with reaffirmations altogether, because there is that paternalistic element in the bankruptcy academic community which says the debtors are too stupid to decide when they should take on more debt.

The real problem in reaffirmations is twofold. One is that attorneys are not fulfilling their ethical responsibility to counsel their clients about whether a reaffirmation is a good deal or not. The Sears case is entirely separate because that was illegal activity taking place totally outside the supervision of the bankruptcy court. If the debtors' attorneys were doing their job, and even Mr. Klein I think recognized before the Commission, as did many, many practitioners and judges, the debtors' attorneys do not represent their clients well here. Furthermore, many courts do not take their responsibility seriously enough to oversee the reaffirmation agreements, as they required to do. So that problem could be cured today.

Mr. GEKAS. Yes. Thank you, Judge Jones.

The gentleman from New York is recognized for 5 minutes.

Mr. NADLER. Thank you.

I would point out, of course, that Judge Jones' comments are a little in-apropos since most debtors do not have lawyers because they are representing themselves; they are pro se. So it isn't a question——

Ms. JONES. That is not true, sir.

Mr. NADLER. Well, it is true.

Ms. Miller, you represent the Commercial Law League, which represents creditors as well as debtors, correct?

Ms. MILLER. That is correct, sir.

Mr. NADLER. Now Mr. Hammonds from MBNA said in his testimony that this legislation would reduce litigation. Do you agree? And what would be the impact on commercial cases if we flood the bankruptcy courts with this sort of consumer litigation? How would that impact business liability, the payment of commercial debts, and jobs?

Ms. MILLER. Let me suggest the following: No. 1, I don't agree with his observation. If anything, the means test opens up the door to loads of litigation, not only in terms of whether or not you fall within or outside the standard, but also under the IRS standard—there is all sorts of litigation regularly over whether or not you fall within the standard. That same litigation is going to take place in this context.

Once a trustee determines that a debtor doesn't meet the standards, he files a motion to have the case dismissed. The debtor is not going to necessarily roll over and not appear at that hearing. After that takes place, then he is going to—the next motion is going to be, nevertheless, I fall within the extraordinary circumstances to justify being here. That is going to be an intense factual determination. Then, provided you get past that, then you are going to have the trustee's motion filed against debtor's counsel for abuse.

Now with all of these matters being brought before the court, it has to clog the docket and increase the cost and expense of administering these cases. And who is going to pay for that? Who is going to pay for the trustee's time to do that? Who is going to pay for the court's time?

Mr. NADLER. How would this impact on commercial cases?

Ms. MILLER. With regard to commercial cases, it is not just the needs-based testing, but you have to look, as Professor Warren has indicated, and some of the other proposals that are in the Bill, the presumed nondischargeable in many cases pits the nondischargeable creditors against the trade creditors, the unsecured creditors who are looking for the same dollars. By increasing the nondischargeable class of creditors in a chapter 13, and not considering classification issues at the same time, you are not making a chapter 13 plan feasible anymore.

Another provision where you have an anti-lien-stripping provision for 5 years, if, in fact, you require that all of these claims be paid the full amount, whether or not it would be a secured claim under applicable State law, or would otherwise fit within section 506(a), again, there won't be anything left for the unsecured creditors. This is not a Bill that helps unsecured creditors get paid. It really is special interest in many, many ways.

Mr. NADLER. Thank you. Let me ask one other question quickly, because I want to turn to Professor Warren.

The Small Business Administration has criticized the inflexibility and the burdensome nature of the requirements on small business reorganizations. Do you believe that this section would needlessly force many small businesses into liquidation instead of survival?

Ms. MILLER. The Commercial Law League of America and the National Bankruptcy Conference have sponsored a joint small business proposal which differs in a number of important respects from the current small business proposal that is contained in Title 4 of H.R. 833. Let me see if I can tell you—and I do think that, without the changes that are contained in our joint proposal, the ability of a small business to succeed and successfully reorganize is going to be hampered significantly.

Mr. NADLER. So don't go into details, except to say right now that, under this bill as written, you think it true that businesses that could survive now through reorganization would, in fact, be forced into liquidation?

Ms. MILLER. Particularly with the stringent deadlines and the lack of flexibility and the amount of small businesses, 85 percent of them would fall within the debt limits that are currently——

Mr. NADLER. Thank you. Thank you.

Professor Warren, the National Bankruptcy Review Commission overwhelmingly rejected the type of means test in this bill, correct?

Ms. WARREN. That is correct.

Ms. JONES. That is not correct. We didn't consider it.

Mr. NADLER. Excuse me.

Ms. JONES. I'm sorry.

Mr. NADLER. Oh, I am sorry. Can I ask unanimous consent for additional time, so that Judge Jones can continue her interruption?

Ms. WARREN. Why don't you let her do that?

Mr. NADLER. Seriously. Without taking off my time, I would like to hear from her.

Mr. GEKAS. I might take it off your time.

Mr. NADLER. Well, then I don't want to hear from her. [Laughter.]

Mr. GEKAS. Then we will do it on my time.

Mr. NADLER. That is fine. By all means.

Mr. GEKAS. What is the official action or non-action taken by the Commission relative to means testing?

Ms. JONES. There was no action. We did not discuss or vote on means testing. Two Commissioners, myself and Jim Shepherd, alluded to it in our dissent with no specifics.

Ms. WARREN. I think we might want to add that it was a proposal that was in front of the Commission, and it was withdrawn by Judge Jones.

Mr. NADLER. Okay. Now I was going to ask you, Professor Warren—thank you—I was going to ask you, I think in your dialog or your colloquy a moment ago, a few minutes ago, with the chairman, I think you were talking past each other, frankly. Forget the means test. We are not now talking about the means test. Is it your testimony that other provisions in this bill, in addition to the means test, such as the nondischargeability, various increases will greatly burden low-income people, people who would never pass a means test?

Ms. WARREN. Congressman, I don't support this version of the means test.

Mr. NADLER. I understand that.

Ms. WARREN. But if this Congress passed just this means test, and not another word that is in this bill, it would have this much [indicating] impact on debtors——

Mr. NADLER. Very modest?

Ms. WARREN. If it turns out that they passed all of the other provisions and left out means testing, the effect on the very poorest debtors, the effect on the most stressed debtors, the effect on the debtors who can least afford to go into court and litigate it would be the same.

Mr. NADLER. Thank you. I have one further question. I was talking last night to a legislative affairs representative of one of the major credit card companies, who specifically told me I was wrong in one aspect of my understanding of this bill. I won't tell you what I said. So let me just ask you the question. The question is——

Ms. WARREN. We will see if I can guess.

Mr. NADLER [continuing]. Is it correct or not—does this bill operate in such a way that the bill provides that in chapter 13, you cannot confirm a plan unless the debtor can make certain payments? Now is it correct that some debtors, could be faced with a Catch-22 situation that they failed the means test because they are too rich for chapter 7; they are pushed into chapter 13, but, because they don't have enough income, they don't have enough actual disposable income, they cannot make the minimum payments; therefore, a plan cannot be confirmed? So they are too rich for chapter 7 and too poor for chapter 13, and can't get any relief at all?

Ms. WARREN. Yes, Congressman, that will happen.

Mr. NADLER. Could you explain that, how that could happen?

Ms. WARREN. We are driving them out of 7 with the means test, but at the same time we are making it much more difficult to confirm a plan in chapter 13. We make it more difficult through eligibility. We make it more difficult through the requirements of what must be paid, how secured creditors must now be paid their entire debt under this bill, and interest. We make it more difficult for

them to get into chapter 13. So that leaves, or will leave, a significant portion of people with is the ultimate Catch-22. They will be, as you quite rightly state, too rich for chapter 7 and too poor for chapter 13, which means their creditors can continue to collect from them forever.

Mr. NADLER. Can I ask the Chair if we can continue for two more minutes? I have one question of Professor Warren and one of Ms. Miller, please.

Mr. GEKAS. We will compromise: 1 minute and 48 seconds, not a second more.

Mr. NADLER. Thank you.

Ms. Miller, could you just comment on what Professor Warren has just said? Do you agree with that?

Ms. MILLER. I agree with it, but I also would like to elaborate on the following: You also could have someone that doesn't meet the qualifications of 7 because they are too rich and, based upon their amount of debt limit, may not fit within chapter 13, and may be forced into an 11, which is completely unfeasible for individuals; it is very costly, extremely costly.

Mr. NADLER. Thank you.

And my last question is for Professor Warren. It is a different question. It is just for clarification. Now assuming that I had a job at which I was making $75,000 a year, and I was laid off from that job. I made $75,000 a year for the last 6 years, and now I have very little or no income. I am making $15,000 or $20,000 a year for the last month since I got a job. Do I pass the means test because it looks backward? In other words, is the means test backward-looking, which may not reflect my current status? Second, is a chapter 13 repayment schedule supposed to be based on my presumed prospective ability to repay, so I assume that the means test and the repayment plan could look at completely different things?

Ms. WARREN. Yes, Congressman, I think that is exactly right. Not only is it backward-looking, which means you can pull in a period of high income, but it has a particularly pernicious effect on an area like bankruptcy, where the one thing we know about debtors in bankruptcy is they have highly erratic work schedules. These are people who have fallen off the high-income ladder and are on their way down.

Many of the debtors in bankruptcy who have high annual incomes—I say, "high"; this is all relative—$30,000, $40,000, $50,000 a year—have them because of earnings in the first part of the year. They have much lower earnings by the time of the filing, and will have much lower earnings in the future.

Mr. NADLER. Because they got laid off or something?

Ms. WARREN. That is right. We have to remember that these debtors not only will fall into the means test screen, but they are not disaster-proofed because they filed for bankruptcy. The same problems that caused them to have trouble with their jobs beforehand are likely to continue to be there post-bankruptcy.

Mr. GEKAS. The time of the gentleman has expired.

Mr. NADLER. Let me thank the chairman for his indulgence.

Mr. GEKAS. Seizing the gavel for a moment, Ms. Miller, in response to some of the questions, you felt that the means test would

cause additional litigation and more cases going to appeal and for fact-finding, and all of that. Is that correct?

Ms. MILLER. Absolutely, sir.

Mr. GEKAS. Do you recall the testimony of Judge Kenner in which she was worried about reaffirmations, and that she felt that what should be done in any reform is to compel every reaffirmation to have judicial review. Do you agree with that?

Ms. MILLER. I am not prepared today, on behalf of the League——

Mr. GEKAS. Oh, you are not prepared?

Ms. MILLER [continuing]. To tell you whether or not I do or I don't——

Mr. GEKAS. I ask you to prepare for it.

Ms. MILLER [continuing]. But I will be happy to get you a position on that.

[The information referred to follows:]

COMMERCIAL LAW LEAGUE
OF AMERICA,
Chicago, IL, March 17, 1999.

Hon. GEORGE W. GEKAS, *Chairman,*
Subcommittee on Commercial
and Administrative Law,
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR REPRESENTATIVE GEKAS: During the Joint Hearing of the Subcommittee on Commercial and Administrative Law of the Committee on the Judiciary of the United States House of Representatives and the Subcommittee on Administrative Oversight and the Courts of the Committee on the Judiciary of the United States Senate held on March 11, 1999, Judge Carol J. Kenner from the United States Bankruptcy Court for the District of Massachusetts, Boston, Massachusetts, recommended that all reaffirmation agreements be subject to court approval. During my subsequent testimony at the Joint Hearing you asked whether the Commercial Law League of America (the "League") supported this recommendation and whether it would result in "clogging the courts," a criticism advanced by the League with respect to adoption of the "needs based" provisions of the Bankruptcy Reform Act of 1999, H.R. 833 (the "Bill").

Prior to the Joint Hearing, the League had not yet considered whether all reaffirmation agreements should be subject to approval, and therefore, I was unable to respond to your question. Since the conclusion of the Joint Hearing the League has considered Judge Kenner's suggestion. While the League has supported the standards for reaffirmations contained in Section 110 of the Bill, it does not believe that it is necessary for the court to oversee and approve whenever a debtor seeks to reaffirm a debt.

Prior to the 1994 amendments, Section 524 of the Bankruptcy Code (the "Code") required the court to approve reaffirmation agreements. In many cases, the courts did not conduct hearings, and the requirement of court approval was merely a procedural formality. That section of the Code was amended in 1994 to provide that the reaffirmation agreement be accompanied with a declaration or affidavit of the attorney that represented the debtor during the course of negotiating such an agreement. The declaration or affidavit must state that such agreement represents a fully informed and voluntary agreement, such agreement does not impose an undue hardship on the debtor or a dependent of the debtor, and the attorney full advised the debtor of the legal effect and consequences of the agreement and a default under the agreement. The court is only required to approve the reaffirmation if the debtor is not represented by counsel. *See*, 11 U.S.C. § 524(c)(3)(A), (B) & (C). To return to the prior procedure is unnecessary and would clog the courts. Moreover, Judge Kenner believed that amendment of the procedure would address some of the abuses recently publicized in the Sears litigation. That litigation, however, was not the result of the standards for reaffirmations set forth in the Code, but rather creditors' failure to comply with these standards. Requiring all reaffirmations to be subject to court approval would not remedy that abuse.

The League was honored to testify at the Joint Hearing last week, and would be pleased to comment on any additional concerns or queries regarding the pending bill or other matters of concern to your office.

Very truly yours,

JUDITH GREENSTONE MILLER,
Co-Chair, Legislative Committee,
the Commercial Law League of America
and its Bankruptcy & Insolvency Section.

cc: Louis A. LeLaurin III, President of the League
Mary K. Whitmer, Chair B&I Section
Jay L. Welford, Co-Chair, Legislative Committee
Max G. Moses, Executive Vice President
David P. Goch

Mr. GEKAS. Because those two positions are a little bit opposite. On the one hand, if you agree with Judge Kenner, you are increasing caseload, number of cases, number of reviews, et cetera. In rejecting our means test, which you say is overloaded with the possibility of more cases, you have to bring that into balance for me.

Ms. MILLER. Let me suggest the following: You need to make a distinction——

Mr. GEKAS. I have already.

Ms. MILLER. No, no, no, no. There is a different distinction that I wanted to bring to bear. You need to make a distinction between a mandatory means test that must be applied in 100 percent of the cases, so that it potentially triggers more litigation before the court, versus a discretionary means test that gets applied when there is evidence that it needs to be applied.

Mr. GEKAS. But Judge Kenner's proposal doesn't account for any discretion at all. Her position is that every case should be reviewed in reaffirmation.

Ms. MILLER. But I am talking——

Mr. GEKAS. That is what she said.

Ms. MILLER. My discretion is not—my discretionary, flexible totality of circumstances test is with regard to the application of a means test——

Mr. GEKAS. I understand that.

Ms. MILLER [continuing]. And abuse, not with respect to reaffirmation.

Mr. GEKAS. But I am saying to you, it is possible that you don't mind, because you haven't made that clear yet, the prospect of having every single affirmation become the subject of a judicial review, but you do worry about the extension of the——

Ms. MILLER. I am not prepared to say that, although——

Mr. GEKAS. Yes, that is what I say.

Ms. MILLER.—I will say that this:

Mr. GEKAS. Thank you.

Ms. MILLER. The one thing I can say is we have been on record that sections 116 and 117 of the Bill that attempt to preclude remedies for abusive reaffirmation practices by precluding class actions, and, ultimately, what would have precluded the Sears litigation, is inappropriate, and, rather, you have to define your abuses more carefully.

Mr. NADLER. You say inappropriate——

Ms. MILLER. Inappropriate to take a remedy away from those who don't have any other feasible remedy in order to remedy the abuse.

Mr. GEKAS. The time of the gavel has expired. The lady from Wisconsin is recognized for 5 minutes.

Ms. BALDWIN. Thank you, Mr. Chairman.

Had my time not expired in the questioning of the last panel, I had intended to ask a question concerning the role that consumer education, might play in responding to the crisis being articulated today. I recognize that much of that can't be reached through the bankruptcy code, although there are provisions certainly that can reach that. I am interested in the impact of real prevention in terms of consumer education in public schools all the way through counseling in the context of avoiding a bankruptcy at the other end.

I am intrigued, Professor Warren, after hearing your research about the typical debtor, and the circumstances that they have experienced that might have led them to file bankruptcy. I am concerned that that might have diminishing effects of consumer education, if, in fact, the crisis is, for example, a healthcare crisis. I am actually surprised by how low the figure is, one in five. I know last October when the Census Bureau indicated 43.4 million uninsured Americans, and the number is going up. I am sure many of those people filing bankruptcy are healthy; yet, I am surprised that there isn't a greater crisis with regard to a healthcare origin.

What do you think the role of education can be in responding to some of the tremendous increases we have seen in bankruptcy filings?

Ms. WARREN. Congresswoman, you ask a very thoughtful question. I can only give this answer: These are people, by and large, who just had problems. They stumbled in the road, that is the right way to think of them. For some of them, it would make no difference how educated they are. If a child develops leukemia and the expenses far exceed their medical coverage, this is a family that will end up in bankruptcy. A million dollars' worth of medical debt will do that to virtually anyone.

But there is a factor that matters here: how much consumer debt these people take on during times that are not the troubled times. If we look at the data over this century, consumer debt and consumer bankruptcies move almost in perfect track. So that when Professor Zywicki wants to talk about whether there was a time when there was a lot less bankruptcy—yes, and there was also a time when there was a whole lot less consumer debt. This data comes from Congressional Budget Office research and other research, Professor Ausubel, economist, independent economists, Professor Moss at the Harvard Business School. But when you look at it, consumer debt and bankruptcy are moving together.

Where education can make a difference is to warn people, in effect, about the dangers of ever having taken on that much debt. A family that divorced in 1970 statistically had about $250 worth of consumer debt when they divorced. A divorce was still tough economically. You had to get two places to live, and you had to divide an income or two incomes that had supported one household, and break it into enough to support two households. That same family today, when it divorces, as we have seen them picked up in bankruptcy, is often carrying $15,000, $20,000, $30,000 worth of credit card debt. They simply cannot survive. They have spent so much

of their future income, so much of their marginal income, they can't divide into two households and still manage to survive.

The real point here, if you really want to talk about education, is in disclosures; it is in getting information to people to understand the risk they take on when they take on this kind of consumer debt. I fear, Congresswoman, that the world that we are living in is a world in which the financially sophisticated are learning how to prey on the financially unsophisticated. If we don't find ways to balance that, then we are in a lot bigger trouble than what is happening in this bankruptcy system.

Ms. BALDWIN. I would be happy to yield the rest of my time to the gentleman from New York.

Mr. NADLER. Thank you.

I would just ask, Professor Warren, you said you fear that the world we are living in is a world in which the financially sophisticated are learning new ways to prey upon the financially unsophisticated. Would it be a fair characterization of this bill to say that this bill, at best, would be a new way for the financially sophisticated to prey on the financially unsophisticated, as drafted?

Ms. WARREN. Yes, Congressman Nadler, I would say that.

Mr. NADLER. Thank you.

Mr. GEKAS. That is on the verge of being insulting, but I will accept the insult as being the last note of the day.

This hearing is now adjourned, with the thanks to the members of the panel who presented views that will get us thinking, I am sure. Thank you very much.

[Whereupon, at 5:24 p.m., the subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

PREPARED STATEMENT OF HON. RUSS FEINGOLD, A U.S. SENATOR FROM THE STATE OF WISCONSIN

I want to thank Mr. Chairman Gekas for hosting this joint hearing with the Senate Subcommittee on Administrative Oversight and the Courts. I appreciate his hospitality and willingness to accommodate the schedules of those of us from the Senate.

I also want to thank Mr. Chairman Grassley for the work he has done on the bankruptcy issue, and the courtesy that he and his staff have extended to those of us who have different views of what needs to be reformed in this bankruptcy system. I sincerely hope that once again we can work together to develop a product that will win a near unanimous vote in the Senate as last year's bill did.

Bankruptcy legislation is obviously a challenging issue for all of us. The stakes are high and the different viewpoints are passionately expressed by all of the players involved, from the different types of creditors to bankruptcy judges, trustees, and practitioners, to consumers and debtors. My view is that the legislation that came out of conference last year and that is now embodied in this year's House bill is not a balanced piece of legislation. It tilts the scales too far in favor of creditors, creating a new special status for certain credit card debts to the detriment of women and families in this country seeking to collect alimony and child support and state and local governments seeking to collect tax liabilities.

The bill contains some provisions that in my view are almost indefensible, such as the requirement that debtor's attorneys bear personal responsibility for the trustee's costs and fees if the debtor loses a motion to convert a Chapter 7 filing to Chapter 13. That provision will have the result of denying many debtors adequate legal representation, making them even more subject to abusive and predatory practices by creditors.

I am very concerned that we are moving too quickly on this issue, and that if reform such as that contained in this year's House bill becomes law its unintended consequences may be even worse for consumers than the consequences we know about now. In light of that fear, Mr. Chairman, I cannot leave you without commenting on what to me is a very troubling aspect of this debate.

More and more the sense I get from talking to both experts in the field and average folks is that while there are some helpful and discrete reforms that could be made to our bankruptcy system, it is not in need of the wholesale revision contemplated by many in this room. And yet, there has been a massive lobbying push by creditor interests for this legislation. New analysis of reports recently filed under the Lobbying Disclosure Act shows that banks and other financial services firms spent more than even the tobacco industry on lobbying in the last six months of 1998.

And reports from good government organizations have noted that this lobbying is accompanied by substantial and highly targeted campaign contributions. I'm informed for example that one company gave a total of $25,000 in soft money to my party within days of the House passage of the bill last June. And another company gave $200,000 to the Republican party just two days after the conference report was issued last year, the very day that the report passed the House. Soft money giving by the consumer credit industry to our political parties increased from $1.2 million in the 1992 election cycle to more than $5.5 million in the 1996 cycle.

Mr. Chairman, I ask that studies by Common Cause and the Center for Responsive Politics on campaign contributions by the consumer credit industry be placed in the record of this hearing.

We need to be cognizant as we proceed here of the extent to which bankruptcy reform has come to be seen as a gift to certain special interests. We bear a heavy burden, I believe, to make sure that we are serving the public interest with this land of far reaching legislation. We cannot meet that burden unless we slow down and open our minds to the recommendations of nonpartisan experts in this field and try to make sure we don't make some very big mistakes with this bill.

PREPARED STATEMENT OF HON. JOHN CONYERS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

The legislation introduced by Rep. Gekas being considered by the House and Senate is an extreme and one-sided bill. *Although the legislation is good for the credit card industry, it is bad for low income people, bad for women and children, bad for minorities and seniors and bad for working Americans.* I plan to do everything in my power to fight this legislation and see that it is either defeated or vetoed.

First off, the bill's means test is fatally flawed—The legislation attempts to impose a one-size fits all income and expense test based on IRS standards to determine who is eligible for bankruptcy relief and how much they are required to pay their creditors. The problem is that the formula fails to take specific account of such important items as child care payments, health care costs, the costs of taking care of ill parents, and educational expenses, to name but a few glaring loopholes.

Secondly, the bill grants creditors unfettered new rights to file threatening new discharge motions against persons with income well below the median. *These motions intimidate poor debtors into reaffirming their credit care and other unsecured debt, often at the expense of being able to pay their mortgage and other priority obligations.*

QUESTIONS FROM SENATOR GRASSLEY FOR PANELISTS

QUESTIONS FOR PANEL ONE:

Larry Nuss

1) How much has the Cedar Falls Credit Union lost due to bankruptcy filings?

2) Could you comment on how many chapter 7 cases you encounter versus the number of chapter 13 cases you encounter?

Bruce L. Hammonds

1) How do you respond to criticism that the credit card industry is largely responsible for the explosion of bankruptcy filings by passing out credit too easily?

2) Your industry has experienced high losses recently due to bankruptcy. If we don't do bankruptcy reform, in your view, will we see a rise in interest rates for loans to consumers?

Dean Sheaffer—National Retail Federation

1) In light of the Sears case, is the Retail Federation currently developing guidelines for its members on how to lawfully seek reaffirmations?

Judge Kenner

1) I am very sympathetic to idea that there's a problem with debtors being coerced into reaffirmations by abusive or deceptive creditor practices. However, it seems to me that there are already harsh sanctions in place to punish improper creditor conduct. Just look at the Sears case where post-discharge injunction combined with State and Federal deceptive practices law resulted in Sears paying over 160 million dollars to settle class action settlements, and penalties. Given what happened to Sears, why shouldn't conclude that what we need is better law enforcement of existing laws, not new laws?

2) As you know, the judicial conference uses a formula that assesses the workload of bankruptcy judges in order to figure out when to request new bankruptcy judges. In your written statement, you suggest that we need more court hearings and judicial review of reaffirmation. Of course, those proposals are likely to cause the formula to show that we need more and more bankruptcy judges. Have you considered how your proposal to require court approval for all reaffirmations affect the staffing formulas? Have you run your proposals by the relevant committees of the judicial conference?

QUESTIONS FOR PANEL TWO:

Judge Jones

1) You are a Federal Appeals Court judge who hears bankruptcy appeals. Do you think a bright-line rule with respect to means-testing helps judges make clear and consistent decisions?

2) During your tenure on the Bankruptcy Review Commission, did you propose a means-testing provision?

Professor Zywicki

1) You mentioned that means-testing would affect a maximum of all bankruptcy filers, do you know what percentage of filers are reported to be repeat users of their "fresh start", and can you comment on what this number suggests about the current remedies in the consumer bankruptcy system?

2) How will means-testing improve the consistency and objectivity in the application of the bankruptcy code?

FOLLOWUP QUESTIONS FROM SENATOR TORRICELLI

FOR MBNA:

In the Senate bill that passed 97 to 1 last year, there was a provision requiring that credit card monthly statements disclose additional information about the cost of that credit, most of which I imagine you already have in your computers. That provision did not survive in the Conference Report and is not in the new Gekas bill. In its place appeared a provision that gives more standard information, but that most people believe will not be very helpful, and some people believe may be misleading. Do you support the idea of giving consumers more information about the cost of their credit?

If we are going to overhaul the bankruptcy system in response to concerns about credit industry losses, we are going to need to evaluate the actual loss data. Can you provide us with that information?

It generally is reported that credit card lending may be the most profitable lending activity, notwithstanding all of these bankruptcies. Except for teaser rates (or "permanent introductory rates") the average interest rate on credit cards remains pretty high, particularly for many middle class and the working poor, even though your cost of funds is low. How can I be sure that if we make the changes you want, that this time you are going to pass along the savings to my constituents?

It is all well and good to encourage people to file for chapter 13 to pay more of their debts. However, the current success rate in chapter 13 is not so good—⅔ of confirmed plans fail, many before paying any unsecured debt. Do you have any data on how you fare in chapter 13 today?

How would the proposed change to the valuation of secured claims (e.g., the elimination of the stripdown and adding to the value any past interest and penalties) affect the goal of the means test to increase the return of unsecured creditors?

FOR JUDGE KENNER:

Based on your experience over the past several years, if you had to choose between the bankruptcy laws as of 1983 (mandatory court reaffirmation review) and the bankruptcy law of today (no mandatory court reaffirmation review), which do you think best fulfills our intent to provide meaningful debt relief in chapter 7 for honest, hardworking, middle class American families?

You mentioned in your testimony that some debtors reaffirm debts after being accused by a credit card company of committing an act that makes those debts nondischargeable, whether or not they are guilty, because they cannot afford to defend themselves in a court hearing. What will be the effect of adding more exceptions to discharge that make it easier for credit card companies to argue that their debts are nondischargeable?

Some creditor representatives have dismissed suggestions that widespread illegal reaffirmation practices demonstrate that reaffirmation review not necessary because "the system works." Are they right?

FOR GARY KLEIN:

We have been told in the past that there is a difference between provisions that are "debtor friendly" and those that are "consumer friendly". For example, some people have argued that provisions protecting the fresh start for honest families work hardship on other consumers who never file for bankruptcy. And, on the flip side,

we have been told that by restricting debtors' rights, we will make the price of credit, goods and services cheaper for nonbankrupt consumers. As an advocate of both debtors and of consumers, can you comment on whether this distinction is real? Are the interests of bankrupt debtors and middle class consumers conflicting?

FOR CREDIT UNION REPRESENTATIVE:

Credit unions tend to be very careful lenders, leading to far lower loss rates than other types of creditors. Some of your members/borrowers find in their mailboxes solicitations for more credit. Certainly no one is forcing them to accept it, but some of them underestimate their financial vulnerability and are attracted by the "teaser" interest rates. With this extra debt burden, they cannot weather hard times and default on their obligations. Does it bother you that the lending practices of large for profit lenders are increasing your losses? Do you think you deserve better treatment in bankruptcy because you at least are trying to lend only to those people who are more likely to be able to repay?

FOR BON TON REPRESENTATIVE:

In light of the problems retailers have had with their reaffirmation practices, how can one justify banning class actions for illegal reaffirmation practices when class actions often are the only way that middle class people have a remedy for wrongdoing against them?

In light of the problems retailers have had with their reaffirmation practices, do you agree that more should be done in this bill to respond to creditor overreaching? What is the justification for focusing almost exclusively on debtor abuse?

Do you offer shoppers one time incentives to sign up for a Bon Ton charge card? Are obligations on Bon Ton charge cards secured or unsecured by the items your customers purchase in your store? If they are secured, how do you make your clients aware that their purchases are secured? If they are secured, does this mean that you offer an interest rate that is lower than the interest rate on the average unsecured credit card?

Let's say I am a Bon Ton customer. I buy a variety of reasonably priced items at your store and have carried a balance on my charge card over the past several years, making only the minimum payment each month. If I file for bankruptcy today, is my debt to your store secured by all of these items? Can you come and take them away if I do not pay after bankruptcy?

FOR PROFESSOR WARREN:

Although there has been a lot of focus on the means test, can you explain the practical effect on families and children of making it easier for credit card companies to claim that their debts are nondischargeable and survive bankruptcy? The First Lady, women and children advocates, and others have expressed a lot of concern about those provisions.

In the prior panel, Judge Kenner explained how current reaffirmation law was not fulfilling our Congressional intent to prevent certain more aggressive creditors from nullifying the discharge, to the detriment of other creditors and the debtor's family. Why shouldn't the debtor be free to agree to pay debts if he so chooses?

You have told us that changes to one provision can have unintended effects on other provisions. Can you close the link for us? What is the connection between imposing a means test, increasing the exceptions to discharge for credit card debts, and failing to reform reaffirmation practice?

You and others have linked the bankruptcy filing rate to consumer debt such as credit cards and the like. Yet, the consumer credit industry has told us that this explanation cannot be correct because the percentage of credit card debt in bankruptcy cases is under 20% and therefore is too small as compared to the total debt in bankruptcy to be the culprit for the filings. How do you respond to this?

No one can refute that the filing rate is very high. Can you explain why your research and research being done at the Harvard Business School suggests that the increase is not attributable to a decline in stigma?

FOR JUDY MILLER (COMMERCIAL LAW LEAGUE):

Some people have argued that individuals and groups voicing opposition or concerns about the bill are simply trying to block reform and believe that abuses should not be addressed. If this is the case, why is a creditor oriented group like the Commercial Law League of America voicing objections about the bill?

You seem to have some serious concerns about the means test in this bill and its ability to identify debtors who can pay back their unsecured debts. As a representa-

tive of many unsecured creditors, your opinion on this is obviously significant. Are you saying that unsecured creditors are unlikely to benefit from this means test? If so, how should we fix this problem?

FOR JUDGE JONES:

You have commended Congress for rejecting findings of the National Bankruptcy Review Commission, of which you were a member. However, 7 out of 9 Commissioners chose *not* to recommend to Congress that it consider a formal means testing system. Now we have heard that the only recent independent study on this subject, sponsored by the American Bankruptcy Institute, found that even if we did turn the system upside down, only a small portion of chapter 7 debtors could pay even 20% of their debts. In addition, we have a witness here who often represents unsecured creditors and who is telling us that she thinks the means test does not work. In light of these factors, why should we move to a formulaic means testing system?

Supporting the concept of needs based bankruptcy is one thing; supporting the *details* of this bill's means testing approach is another. Even if you support a "means based" system in theory, aren't you concerned by the logistical problems that have been identified regarding this means test by the Commercial Law League, trustees, judges, and the National Bankruptcy Conference?

As a judge, do you think it is appropriate to make debtors' lawyers personally and financially responsible if their clients are found to have filed under the wrong chapter?

Even if we make it less "easy" to file for bankruptcy so that the filing rate goes down, it seems to me that we have looked at only one half of the problem because some people are going to default on their obligations whether or not they "discharge" their debts in bankruptcy. Can you comment on this? Do you think that more needs to be done to help prevent people from incurring so much debt in the first place?

Using conservative economic theories, some researchers believe that restricting bankruptcy laws will increase defaults and ultimately increase bankruptcy filings. Do you disagree with those conservative economists?

FOR PROFESSOR ZYWICKI:

The means test in this bill relies heavily on the IRS collection allowances. We have heard lots of concerns about these allowances, even from those who take no position on the bill generally. One problem is the "other necessary expense" category. Since it clearly was not designed for this purpose, the items that fall into the category are totally discretionary with the IRS and are approved on a case by case basis (see IRS regulations 5323.434). Thus, we have no guarantee that these expenses may be deducted from the means testing formula. This is not simply a minor inconvenience; families in bankruptcy will need to use this category for such things as health care, child care, disability insurance, union dues, and court-ordered payments (such as support), because the IRS collection allowances do not cover these critical expenses anywhere else. How is this supposed to work?

The means test in this bill requires a trustee to do a complete ability to pay analysis under the means test in every single chapter 7 consumer case at the very beginning of the case, 10 days before the 341 meeting, before the trustee has even met any of the debtors. People who actually work in the bankruptcy system say that this simply is not feasible. In addition, the trustees would not even be compensated for this extraordinary expenditure of time. Don't you think that there are serious feasibility requirements with the means test?

As a law professor who has studied the bankruptcy system, do you believe that it is appropriate to give lawyers a financial disincentive to file chapter 7s for their clients if they believe that doing so is in the best interest of their clients? Are you concerned that creating such financial disincentives for lawyers to act in their clients' best interests will run afoul of other ethical requirements?

FOLLOWUP QUESTIONS FROM SENATOR RUSS FEINGOLD

TO BRUCE HAMMOND:

1. You testified that the number of consumer bankruptcy filings in 1998 represents an increase of nearly 400% since 1980.

A) Please provide comparative information on the amount of credit card debt issued by MBNA in 1980 and 1998.

B) Please provide comparative information on MBNA's non-bankruptcy losses in 1980 and 1998.

C) Please provide comparative information on MBNA's bankruptcy losses as a fraction of total credit card debt outstanding in 1980 and 1998.

D) Please provide the same information for the industry generally.

2. You testified that it is "estimated that more than $40 billion in consumer debt—approximately $400 for each American family—was erased as a result of bankruptcy in 1998." Putting it another way, you later testified that the "Federal consumer bankruptcy system provided an estimated $40 billion of relief to debtors without either objective standards or systematic procedures for determining the actual relief needed by debtors." We also heard in the hearing that the "hidden bankruptcy tax" is now up to $550 a year per family, leading to the suggestion that bankruptcy legislation will result in a $550/year rebate to the American people. Please respond to the following questions:

A) Do you have a source for the $400/$550 a year figures other than the last year's WEFA Group study, which the General Accounting Office determined was not reliable? See "The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan, GAO/GGD–98–116R.

B) Can you explain why the bankruptcy loss figure grew by 35% (from $400 to $550 in a single year) when the growth in bankruptcy filings for the same period was about 1%?

C) Does the $40 billion figure account for debts that were found to be non-dischargeable or that were reaffirmed?

D) Does the $40 billion figure account for the fact that more than half of all chapter 13 debtors never discharge any debt?

E) Does the $40 billion figure account for losses that you would have experienced even if the borrowers never filed for bankruptcy?

3. You testified: "Inevitably, these losses are passed on to all consumers in the form of higher rates and higher prices for goods and services." However, over the past decades there has not been a correlation between the cost of credit and the cost of funds or the number of bankruptcy filings; indeed, interest rates have remained remarkably constant over the past 18 or so years, even though the bankruptcy rate was not. If one argument for reforming the bankruptcy laws in the ways that you support is that it will lower interest rates and prices for our constituents, can you provide us with data showing how losses from bankruptcy have affected the price of credit offered by MBNA in the past?

4. You testified: "Consumers also are harmed by increased bankruptcies when creditors, in an effort to reduce losses, tighten their credit standards and thereby decrease credit availability." Similar testimony has been submitted throughout the 20th century in connection with requests for changes to the bankruptcy system, particularly in the early 1980s when Finn Casperson of Beneficial Finance and other representatives of the credit industry warned that consumer credit would grow scarce if the bankruptcy system was not reformed—and specifically if means testing were not adopted.

A) What happened to the industry prediction of the 1980s? Hasn't credit grown in the intervening years, not contracted?

B) If credit restriction is the predicted result of high bankruptcy filings and losses, have you restricted credit to reduce your losses following the big jump in bankruptcy filings in 1996? If so, how?

5. What are MNBA's policies on extending credit to families that have filed for bankruptcy?

A) Does MBNA offer credit to individuals within 2 years after they receive a chapter 7 discharge? If so, on what terms?

B) What are the industry practices on offering credit to individuals who have filed for bankruptcy?

6. With respect to Chapter 7 cases involving debt owed on and MBNA credit card:

A) In what percentage of such cases does MBNA challenge the dischargeability of the debtor's debt to MBNA?

B) Of those cases where dischargeability is challenged, how many cases are actually litigated?

C) What percentage of debtors do not contest your charge and either admit nondischargeability or reaffirm the debt without any specific findings of fraudulent behavior?

7. I understand that some 3.5 billion credit card solicitations and offers go out each year. Do you think that the credit industry bears any of the responsibility for the increase in personal bankruptcies in this country?

8. You testified that the current bankruptcy system's lack of means testing "undermines not only the integrity of the U.S. bankruptcy system, but also traditional obligations of individual responsibility."

A) Do you believe that MBNA and the consumer credit industry generally has a corporate responsibility to verify the ability to pay of the consumers to whom you offer credit cards?

B) Please explain how many bankrupt consumers with relatively low incomes who end up in bankruptcy have so many credit cards.

9. You testified that "the current bankruptcy system also fails the debtors it is intended to help, because it provides short-term relief without helping debtors avoid the same financial failure in the future."

A) Please explain how the means test in H.R. 833 helps debtors avoid the same financial failure in the future, particularly when the means test benefits those debtors who take on larger debts and declare higher expenses.

B) Do you agree that including additional disclosures on monthly credit card statements that help borrowers understand the cost of credit they are incurring by advising them of their amortization rate and the long term financial effect of making only the minimum monthly payment would help borrowers avoid financial failure in the future?

10. You testified that the implementation of means testing would introduce enormous efficiencies into the bankruptcy system.

A) Section 102 of H.R. 833 requires that trustees conduct a means test review of every single chapter 7 debtor, even those with incomes far below the national median, or even below the poverty level. Do you believe it is efficient to test all chapter 7 debtors, regardless of their income?

B) If an individual with income below the poverty level can pay 20% of her debts because her debts are not large in an absolute sense although they may be overwhelming as compared to her disposable income, do you think such an individual should be denied chapter 7 debt relief and instead should be required to obtain relief only after completing a 3 to 5 year payment plan?

C) The means test in H.R. 833 relies on the Internal Revenue Service collection allowances. However, many expenses do not fit the categories of expenses that are automatically permitted under the IRS allowances. Instead, according to IRS regulation 5323.434, such expenses as health care, child care, dependent care for elderly invalid or disabled, or disability insurance are permissible only on a case by case basis by the IRS. Since the bill requires trustees to scrutinize all chapter 7 filers for ability to pay, how would an elderly person filing for chapter 7 obtain the necessary permission to include her expenses for health care and dependent care?

11. You testified that those debtors who were found to be able to pay the requisite portion of their debts under the means test "would automatically enter a Chapter 13 repayment plan." However, the means test as currently constituted in the House bill does not account for several significant factors, e.g., amounts in default on secured debts and chapter 13 administrative expenses.

A) Isn't it the case that some debtors who are ejected from chapter 7 under the means test in fact will not be able to pay 20%—or any—of their unsecured debts once sent to chapter 13?

B) If so, is it cost-justified to send such debtors to chapter 13 when the annual costs of administering a chapter 13 case (approximately $1,200 per year per case under the current system) outweigh the distributions made to unsecured creditors?

12. Do you disagree with the testimony of Judith Greenstone Miller of the Commercial Law League of America, who cited the finding of the National Association of Bankruptcy Trustees (chapter 7 trustees) that no more than 1 in 10 cases converted under the proposed means test will actually be able to confirm or complete

a repayment plan? If you do disagree, please provide any studies or data that support your view.

13. You stated in your testimony that "bankcard debt represents less than 16% of total debt on the average bankruptcy petition."

A) Please provide us with the source of this statistic and the underlying data supporting it.

B) Since the 16% figure presumably includes secured debt, what percentage of unsecured debt on the average bankruptcy petition that is bank card debt?

C) What percentage is credit card debt, including non-bank card debt?

14. You mentioned in your testimony that credit cards cannot be the cause of the high bankruptcy filing rate because credit cards accounted for a mere 3.7% of consumer debt in 1997 according to the Federal Reserve Board. However, you also have told us that in bankruptcy, bankcard debt alone (presumably a subset of all credit card debt that would include cards of retailers and other types of credit card issuers) is 16% of all debt, including secured debt—meaning that bankcard debt and total credit card debt are a far higher percentage of total unsecured debt in bankruptcy than outside of bankruptcy. Doesn't the disproportionately high amount of credit card debt in bankruptcy, as compared with the population generally, indicate that credit card debt is a serious problem for those individuals who ultimately file for bankruptcy?

15. Your testimony indicates that more than 96% of credit card accounts pay as agreed, and only about 1% end up in bankruptcy, leaving the other 2 or 3% of credit card accounts to be in default without resorting to bankruptcy. This suggests that more credit card accounts default without bankruptcy than with bankruptcy.

A) Even if we restrict the bankruptcy laws as you recommend, what makes you think that this 1% will be collectible when 2 or 3% of your accounts default without discharging their debts under the bankruptcy system?

B) What are MBNA's losses, in dollars, from nonbankruptcy defaults?

C) How do you address the 2 to 3% of accounts that default without bankruptcy? What types of collection or enforcement procedures do you typically use?

16. Most discussions of bankruptcy reform have focused on the means test, which was the subject of the panel on March 11. However, as Gary Klein pointed out at the hearing at which you testified, the bankruptcy bill spans 300 pages and contains hundreds of amendments affecting consumer bankruptcy, many of which we have had little or no opportunity to debate, but we know are quite significant. Since your testimony indicates that means testing is extremely important to you, does this mean that you would be willing to accept a means testing amendment and forgo the remainder of the other consumer bankruptcy amendments, such as the various provisions expanding the nondischargeability of credit card debt?

17. I am interested in your view of the appropriate public policy to be served by a bankruptcy system. Please rank the following potential creditors in a hypothetical bankruptcy case. Who should be paid first, second, etc. from the limited pool of funds available in a bankruptcy case?

Credit card company.
Secured lender on a purchase of an automobile.
Other secured creditor.
Taxing authorities.
Spouse who is owed child support and/or alimony.

18. Please compare two hypothetical cases. (1) Suppose someone takes out a cash advance of $500 on one of your credit cards to go gambling. She loses every penny. A month later she declares bankruptcy. (2) Suppose another person takes out a cash advance of $500 to pay for food for her children and an unexpectedly high heating oil bill. A month later, she files for bankruptcy. Should those two debts to you be treated the same way in bankruptcy?

19. On October 9, 1998, two days after the conference report was filed and the very day that the House passed the conference report, MBNA contributed $200,000 to the National Republican Senatorial Committee.

A) As CEO, are you involved generally in the decisions to make soft money contributions to the political parties?

B) Were you involved in the decision to make this particular donation?

C) How are decisions on soft money contributions made in your company? Who participates in such decisions? What criteria are followed in making such decisions?

D) Why did MBNA make a $200,000 donation to the NRSC on October 9, 1998?

20. Do you believe there are any creditor abuses in the bankruptcy system that should be addressed in bankruptcy reform legislation? If so, what are they?

TO LARRY NUSS:

1. You report in your testimony that National Credit Union Administration data show that credit unions had approximately 253,000 members file for bankruptcy in 1998, an increase over the 250,000 filings in 1997.

A) What was the total number of members in the credit unions that were the subject of the NCUA statistic in 1998 and 1997, and the percentage of credit union accounts in bankruptcy in those two years?

B) Unless credit union membership declined significantly in 1998, a 3,000 increase in credit union member bankruptcy filings in 1998 (just over a 1% increase from the previous year) is probably far below the nationwide filing rate increase. Do you attribute this lower increase to self-correction in lending and/or the high standard of care generally used by credit unions when lending to their members?

2. You report that the Credit Union National Association estimates that almost half of all credit union losses in 1998 were bankruptcy-related and that those losses reached $684 million.

A) Does this mean that the bankruptcy losses are $684 million or the total losses are $684 million?

B) To enable us to determine the overall credit union default rate and bankruptcy default rate, what was the aggregate loan portfolio of all credit unions included in these statistics?

3. According to your testimony, your credit union currently has 8,300 members. In 1998, 18 of your members (approximately .02%) filed for bankruptcy. The filing rate among your membership is far lower than the national filing rate. Although the national nonbankruptcy filing rate has increased substantially since 1995, your filing rate in 1998 (approximately .02%) is the same as in 1995 (assuming you had 8,300 members then as well).

A) To verify that your filing rate was approximately the same in 1995 as it is in 1998, how many members did you have in 1995?

B) Do you think that if other lenders were as careful as you are, that the market would fix the current "bankruptcy crisis" without the proposed government intervention?

C) Although your filing rate is nearly identical in 1998 to your 1995 rate (assuming that the number of members has not changed substantially), your losses appear to have increased from $19,848 in 1995 to $34,813 in 1998. If you adjusted your numbers for inflation and reported your 1995 losses in 1998 dollars, how would your losses compare in those two years? If there still is a substantial difference, what accounts for that difference in losses?

4. The losses in dollars that you experienced in 1998 that you have attributed to bankruptcy are only .014% of your loan portfolio. Does this extremely low dollar loss rate, along with your low filing rate, provide further evidence that bankruptcy losses can be contained by the market without unduly restricting credit availability overall?

5. You testified that reaffirmation agreements have been a significant factor in reducing your losses.

A) How many of your bankrupt members reaffirmed one or more debts to your credit union in 1997 and 1998?

B) What proportion of those reaffirmations was for partially secured car loans?

C) What proportion was for credit cards or other unsecured debts?

D) What was the total dollar amount of debt that your members reaffirmed in 1997 and 1998?

6. Your testimony indicates that you believe that your reaffirmation agreements confer a benefit on the debtors who reaffirm those debts. As you know, you may be one of several lenders asking a debtor to reaffirm her debts, and it may be financially infeasible for that debtor to honor all of those commitments. Reaffirmation of other debts may interfere with the debtor's ability to repay your credit union, and other lenders might use more aggressive collection practices and higher fees to encourage the debtor to pay them first.

A) If debtors were not allowed to reaffirm any unsecured debt, would most of your members continue to pay you voluntarily?

B) Do you believe that the benefits your members receive from reaffirming debts to you would make them more likely to pay you than some of their other creditors?

C) Would you support court review of reaffirmation agreements if it did not necessarily require a hearing and could be done inexpensively?

D) Do you believe that reaffirmation agreements should clearly state the terms of the agreement so that debtors can understand the financial consequences of the reaffirmation, similar to the Truth in Lending Act requirements? If not, why not?

7. You testified that you support needs based bankruptcy, in part because you believe that more of your members could repay some of their debt in chapter 13. However, the national statistics on chapter 13 plan completion are low, and many do not distribute much, if any, payments to unsecured creditors.

A) Of the chapter 13 cases your members have filed since 1995, how many were completed or still in payment?

B) How many dollars of unsecured debt have been collected from in the chapter 13 cases of your members since 1995?

C) If one of your members files for bankruptcy, are you better off financially if the member files for chapter 7 and reaffirms her debt to you in full rather than filing for chapter 13 and paying all of her debts pro rata over several years?

8. Most discussions have focused on the importance of the means test, which was the subject of the panel on March 11. However, as Gary Klein pointed out at the hearing at which you testified, the bankruptcy bill spans 300 pages and contains hundreds of amendments affecting consumer bankruptcy that have received little or no attention. Would you be willing to accept a means testing amendment and forgo the remainder of the other significant consumer bankruptcy amendments, such as the various provisions expanding the nondischargeability of credit card and retail charge card debt and the provisions inflating the value of nominally secured debt?

9. In recognition of the lower loss rates and sometimes more responsible consumer lending practices of credit unions, should there be special provisions in this legislation that apply only to credit unions? Should credit unions be treated differently with respect to reaffirmation?

10. Do you believe there are any creditor abuses in the bankruptcy system that should be addressed in bankruptcy reform legislation? If so, what are they?

TO DEAN SCHEAFFER:

1. Your testimony on behalf of the National Retail Federation focuses exclusively on abuse of the bankruptcy system by debtors and does not make any mention of the fact that quite a few retailers have admitted to committing bankruptcy fraud on a widespread basis.

A) Has Boscov's engaged in any post-bankruptcy collection activity without filing reaffirmation agreements?

B) Does Boscov's think that the current laws supervising reaffirmation agreements have been adequate?

C) Does Boscov's support the provisions in the House bill that eliminate class actions to pursue creditors who have systematically violated bankruptcy law to the detriment of consumer debtors? If so, why?

2. Do you believe there are any creditor abuses in the bankruptcy system that should be addressed in bankruptcy reform legislation? If so, what are they?

3. How many of your bankrupt customers reaffirmed their debts to Boscov's in 1997 and 1998? What was the average amount of the debt?

4. How many dollars owed to Boscov's were reaffirmed in bankruptcy cases in 1997 and 1998?

5. How many dollars has Boscov's received in chapter 13 cases filed by its customers since 1995?

6. Do you believe that reaffirmations are a preferable method of reducing Boscov's bankruptcy losses as opposed to chapter 13 plans, in which Boscovs might only receive, as you testified, 30 cents on the dollar or even less?

7. You testified that "it is estimated that over $40 billion was written off in bankruptcy losses last year, which amounts to the discharge of at least $110 million every day. . . . The nation's 100 million households ultimately pay that $40 to 50 billion."

A) Do you have a source for this data other than the WEFA Group study that has been called into question by the General Accounting Office? *See* "The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan, GAO/GGD–98–116R. If so, can you provide us with the supporting data?

B) Assuming that the $40 to $50 billion figure is correct, producing a "hidden tax" on every American family of $400 or $550 a year, can you estimate what portion of that amount actually could be recouped by the Bankruptcy Reform Act of 1999?

C) Have the interest rates on Boscov's charge cards increased/decreased in the past in step with bankruptcy filings and losses that you have attributed to bankruptcy? If so, please document these changes.

D) Has the cost of merchandise at Boscov's increased/decreased in the past in step with bankruptcy filings? If so, please document these changes.

8. You testified that "everyone's credit is tighter" when people use the bankruptcy system as a means of walking away from their debts. Can you document that you restricted your lending, or that the industry generally restricted its lending as a result of the increase in bankruptcy filings?

9. Representing the National Retail Federation, you testified that the emergence of a new phenomenon, surprise bankruptcy filings, is an indication that bankruptcy is becoming a first step rather than a last resort. You said: "Today, we see a very different picture. Often the first indication we receive that an individual is experiencing financial difficulty is when we receive notice of his bankruptcy petition. . . . The first indication of a problem is the notice that they have filed for bankruptcy." In 1983, a representative of the National Retail Merchant's Association and American Retail Federation similarly testified that "a new and substantial class of debtors—one different from the traditional debtor—was also found. These persons were current on their required monthly payments, had little or no previous history of delinquency, and some even had additional credit available on the account at the time the bankruptcy notice was received by the creditor." See Statement of Raymond W. Klein, H.R. Macy & Co., Inc., representing the National Retail Merchants' Association and the American Retail Federation before the Senate Judiciary Committee Subcommittee on Courts (January 24, 1983). Are you identifying the same "new" phenomenon as Mr. Klein did in 1983? If not, how are they different?

10. You testified that the system should be changed to incorporate means testing regardless of what percentage of individuals currently choosing chapter 7 actually could pay any of their debts. However, legislators need to have a better sense of how many chapter 7 debtors are solvent because it is relevant in determining whether the substantial change would be cost-justified. We first heard that industry funded studies predicted that one third of chapter 7 debtors could pay some or all of their debts. Later industry funded studies predicted lower and lower numbers, the latest being 11%. A recent non-industry study sponsored by the American Bankruptcy Institute found that the most optimistic number of chapter 7 debtors able to pay even ⅕ of their debts over 5 years is under 4%, and that the amount of dollars the credit industry will recoup directly from this change is likely to be a fraction of the industry's estimate.

A) Approximately what percentage of chapter 7 debtors do you believe can repay a substantial portion of their debts.

B) How many dollars you believe you will recoup from that system so that we can compare that to the cost to the taxpayers of the change.

11. Most discussion has focused on the importance of the means test, which was the subject of the panel on March 11. However, various versions of the bankruptcy bill span 300 pages and contain hundreds of amendments affecting consumer bankruptcy. Would you be willing to accept a means testing amendment and forego the remainder of the other significant consumer bankruptcy amendments, such as the various provisions expanding the nondischargeability of credit card and retail charge card debt and the provisions inflating the value of nominally secured debt?

TO PROFESSOR TODD ZYWICKI:

1. You testified that "studies repeatedly conclude that those affected by means-testing could pay approximately 60%–70% of their unsecured debts if they filed under Chapter 13, which amounts to a total of over $4 billion." Do you have a source for this $4 billion number, other than the report of the WEFA Group study that did not provide sufficient information for the General Accounting Office to be able to assess the reliability of the data, the reasonableness of the report's assumptions, and the accuracy of the report's estimates of creditor losses and the bankruptcy system's costs in 1997? *See* "The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan, GAO/GGD–98–116R.

2. You testified that "95% of Chapter 7 bankruptcy filings make no distribution at all to unsecured creditors, and those that do rarely pay out more than a trivial amount" and went onto suggest that creditors receive a much larger payout in chapter 13 cases. However, VISA U.S.A. studies and the Creighton University reaffirmation study both indicate that a substantial portion of chapter 7 debtors reaffirm their debts and thus continue to pay one or more of their unsecured debts, notwithstanding the fact that they have no nonexempt property to be liquidated in the course of the bankruptcy case. The chapter 13 plan completion rate is low, and many times plans are terminated before payments to unsecured creditors are commenced. Moreover, some plans are 0% plans and never intend to pay unsecured creditors at all.

A) Do these factors affect your comparison of the benefits of the two chapters?

B) Do you have any data to make a more complete comparison between the payouts from chapter 7 and chapter 13 debtors?

3. You testified that the reach of means-testing is small in terms of the number of filers impacted but that its impact would be large in terms of the amount of money collected. In light of this view, do you believe that it is necessary or efficient to review all cases for ability to pay under the means test, even cases of debtors with income below the poverty level, as section 102 of H.R. 833 currently requires?

4. Your testimony suggests that a means test should identify those debtors with high incomes who could repay creditors, such as the doctor in the case of *In re Kornfield*, 164 F.3d 778 (2d Cir. 1999). Your testimony also suggests that although the current system has been successful in denying relief to debtors such as Dr. Kornfield, current law permits those debtors to continue to contest the denial of relief by filing and litigating appeals. You probably would get little or no argument from debtor advocates that individuals like Dr. Kornfield may not be deserving of chapter 7 relief. However, some observers have questioned whether the means test in H.R. 833 will actually be able to catch someone like Dr. Kornfield; after all, an individual with his sophistication and legal resources will be able to inflate and shape his debts and expenses to escape the means test.

A) Do you agree that the means test in H.R. 833 provides leeway for wealthy and savvy individuals, the Dr. Kornfields of the world, to escape the means test?

B) How would H.R. 833 prevent Dr. Kornfield from taking several appeals as he did under current law? After all, with his legal resources, he could contest the "other necessary expense" category of the IRS collection allowances, which are determined on a case by case basis, and he also could contest any determination of whether he had "extraordinary expenses."

5. You testified that the 1978 Code significantly reduced the economic costs and increased the economic benefits of filing bankruptcy. However, the Code was tightened with amendments proposed by the credit industry in 1984, only to be followed by a sharp increase in filings notwithstanding decreased debt relief. How do you explain this trend?

6. You testified that economist Michelle White estimates that 15%–20% of American households would financially benefit from filing bankruptcy, especially if they engaged in some planning prior to filing. Since a far smaller percentage of American households file for chapter 7 bankruptcy, doesn't this mean that bankruptcy still carries stigma sufficient to deter the vast majority of families who would benefit from filing?

7. Your testimony indicates that you believe that every individual who borrows money or purchases an item should be required to repay it. Drawing the analogy between bankruptcy and shoplifting, you state that "you shouldn't take it if you aren't going to pay for it."

A) If this is the case, do you think that Congress is wrong to provide a discharge in bankruptcy at all?

B) Should society recognize that changed economic circumstances caused, for example, by illness, disability, divorce, or loss of employment might make it impossible for consumers to satisfy debts they had every intention of paying when they incurred them?

C) Are you concerned that the lack of a bankruptcy safety valve will hamper entrepreneurs, who currently comprise one in five consumer bankruptcy filings, from engaging in the appropriate level of risk-taking activity?

8. You state in your testimony that "a borrower's willingness to take on debt clearly will be related to the ease with which he can later discharge those debt obligations if he chooses to do so." This statement assumes that consumers incur obligations with the understanding of their true costs. Some economists believe that many consumers systematically underestimate the extent of their borrowing and the cost of repayment and therefore make sub-optimal borrowing decisions. If this is the case, changing the bankruptcy law will not affect the borrowing decisions of many consumers. To enable consumers to make more rational borrowing decisions that will be less likely to lead them into financial distress, particularly if the bankruptcy laws are going to be tightened and consumer credit remains freely flowing, do you believe that open end credit should be accompanied by additional disclosures that reveal to the potential borrower the actual costs of credit?

9. You testified that consumer credit is not to blame for the bankruptcy filing rate. The credit industry witnesses agreed with you, noting that credit card debt is only 3.7 of consumer credit overall and *bank* card debt (presumably a subset of all card debt) is only 16% of all debt (including secured debt) in bankruptcy. However, don't these numbers alone indicate that the individuals and families who ultimately resort to bankruptcy have inordinately high credit card debts as compared to the population as a whole?

10. You testified that "the credit card industry has revealed itself to be ferociously competitive."

A) If that is the case, why have average interest rates on credit card hardly varied over the past 2 decades since the industry was functionally deregulated by the *Marquette* Supreme Court case, even though the cost of funds declined dramatically in this period?

B) Why have profits in the consumer credit consistently exceeded profits for all other lending activities?

12. As further support for the proposition that the time has come for means testing, you testified: "Access to credit cards are especially important for low-income borrowers, as they lack the options of more wealthy borrowers." However, the means testing provision is one of dozens of changes to the consumer bankruptcy system in the pending legislation. Some of the provisions in the bill will decrease the amount of the debtor's income available for payment of unsecured debt in chapter 13, and in fact may further suppress the chapter 13 plan completion rate. How will these provisions affect the cost of unsecured credit and its availability for low income borrowers?

13. As a professor who has argued vigorously in favor of retaining disinterestedness requirements on chapter 11 debtors' lawyers to ensure that they act in their clients' best interests, do you believe it is appropriate for the bill to impose financial disincentives on lawyers to help their debtor clients file for chapter 7 if those lawyers believe that the debtor is an eligible candidate for chapter 7 and that it is in the best interest of the debtor to seek that relief?

14. As a professor who has studied the bankruptcy system closely, do you see any creditor abuses in the system that should be addressed in bankruptcy reform legislation? If so, what are they?

QUESTION FROM SENATOR KOHL FOR JUDGE EDITH JONES:

The National Bankruptcy Review Commission, which you served on, recommended a $100,000 cap on homestead exemptions. I have introduced legislation that would establish such a cap. We have heard from some of the states with unlimited homestead exemptions that a $100,000 cap would unfairly infringe on states' rights. Cap supporters argue that debtors are using federal courts and federal laws to get bankruptcy relief, and it is fair to make them subject to federal limits in order curb egregious abuses, like the recent example of long-time Florida resident Burt Reynolds who wrote off over $8 million in debt through bankruptcy while still holding onto his $2.5 million estate. Do you agree with this recommendation of the NBRC? Please explain your response, including your reaction to arguments from both sides.

DEAN E. SHEAFFER'S RESPONSES

BOSCOV'S DEPARTMENT STORE, INC.,
Reading, PA, March 25, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR MR. HYDE: Thank you for allowing me to testify before the Joint Hearing of the House Subcommittee on Commercial and Administrative Law and the Senate Subcommittee on Administrative Oversight and the Courts on Bankruptcy on March 11, 1999.

The following are responses to the additional written questions attached to your letter of March 15, 1999.

SENATOR CHUCK GRASSLEY

1) *In light of the Sears case, is the Retail Federation currently developing guidelines for its members on how to lawfully seek reaffirmations?*

NRF's members are keenly aware of the requirements of the law, especially in light of the recent cases involving retailers and other companies that were required to pay huge penalties. The NRF also has held educational meeting for its members emphasizing reaffirmation requirements.

SENATOR TORRICELLI

1) *In light of the problems retailers have had with their reaffirmation practices, how can one justify banning class actions for illegal reaffirmation practices when class actions often are the only way that middle class people have a remedy for wrongdoing against them?*

There is no need for individual class actions; state and federal authorities have more than adequate authority to enforce the law and to recover substantial consumer remedies, as was seen in the Sears case.

2) *In light of the problems retailers have had with their reaffirmation practices, do you agree that more should be done in this bill to respond to creditor overreaching? What is the justification for focusing almost exclusively on debtor abuse?*

The issue in the Sears case was not overreaching, rather it was a failure on the part of the Company to follow proper procedures requiring them to file with the court records of reaffirmations. These creditor requirements are already in the law. We believe fair procedures should be established both for creditors and for debtors and they should be followed.

3) *Do you offer shoppers one-time incentives to sign up for a Boscov's charge card? Are obligations on Boscov's charge cards secured or unsecured by the items your customers purchase in your store? If they are secured, how do you make your clients aware that their purchases are secured? If they are secured, does this mean that you offer an interest rate that is lower than the interest rate on the average unsecured credit card?*

Boscov's does offer an incentive for customers to sign up for our charge card, usually in the form of a discount on their first charge transaction. While Boscov's asserts a "purchase money security interest" in all states except New York, this is a much lower level of security interest than that taken by a traditional secured lender. Our credit card is priced competitively in this market.

4) *Let's say I am a Boscov's customer. I buy a variety of reasonably priced items at your store and have carried a balance on my charge card over the past several years, making only the minimum payment each month. If I file for bankruptcy today, is my debt to your store secured by all of these items? Can you come and take them away if I do not pay after bankruptcy?*

If you file for Bankruptcy, in general, Boscov's would not take away any items purchased on our card prior to a bankruptcy. The only possible exception is that we legally could recover items obtained fraudulently or items which are determined by law to be non-dischargeable.

SENATOR FEINGOLD

1) *Your testimony on behalf of the National Retail Federation focuses exclusively on abuse of the bankruptcy system by debtors and does not make any mention of the fact that quite a few retailers have admitted to committing bankruptcy fraud on a widespread basis.*

A) *Has Boscov's engaged in any post-bankruptcy collection activity without filing reaffirmation agreements?*

Boscov's does not engage in post-bankruptcy collection activity without filing reaffirmation agreements as required.

B) *Does Boscov's think that the current laws supervising reaffirmation agreements have been adequate?*

Boscov's believes current law supervising reaffirmation agreements are adequate.

C) *Does Boscov's support the provisions in the House bill that eliminate class actions to pursue creditors who have systematically violated bankruptcy law to the detriment of consumer debtors? If so, why?*

For the reasons mentioned above, compliance with reaffirmation procedures is not a major problem for Boscov's. However, we believe the existing governmental authority to curb reaffirmation abuses is adequate and has been quite effective.

2) *Do you believe there are any creditor abuses in the bankruptcy system that should be addressed in bankruptcy reform legislation? If so, what are they?*

The bankruptcy abuse that have been brought to my attention, such as a failure to file affirmations, are already addressed severely under current law.

3) *How many of your bankrupt customers reaffirmed their debts to Boscov's in 1997 and 1998? What was the average amount of the debt?*

Sixty-five (65) customers reaffirmed their debts with Boscov's in 1997 and 1998 combined. The average amount of the debt was $621.25.

4) *How many dollars owed to Boscov's were reaffirmed in bankruptcy cases in 1997 and 1998?*

A total of $40, 381.53 was reaffirmed in 1997 and 1998 combined.

5) *How many dollars has Boscov's received in chapter 13 cases filed by its customers since 1995?*

Boscov's received $160,473 in Chapter 13 cases from 1995 through 1998 inclusive.

6) *Do you believe that reaffirmations are a preferable method of reducing Boscov's bankruptcy losses as opposed to chapter 13 plans, in which Boscov's might only receive, as you testified, 30 cents on the dollar or even less?*

Both Chapter 13 plans and reaffirmations, in Chapter 7 cases, may be necessary for customers to honor those payments they can, while affecting a true "fresh start". If a customer seeks to preserve, post-bankruptcy, a small line of credit from a local merchant to purchase necessary items such as school clothes, a reaffirmation may be most appropriate. On the other hand, if an upper-income customer is able to repay 30 cents on the dollar through a Chapter 13 plan, they should be required to do so.

7) *You testified that "it is estimated that over $40 billion was written off in bankruptcy losses last year, which amounts to the discharge of at least $110 million every*

day. . . . The nation's 100 million households ultimately pay that $40 to 50 billion. "

A) *Do you have a source for this data other than the WEFA Group study that has been called into question by the General Accounting Office? See"The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan, GAO/GGD–98–116R. If so, can you provide us with the supporting data?*

Although I do not have specific citations, I believe the Administrative Office of the Courts has reported the level of bankruptcy discharges has exceeded $40 billion per year. It is commonly reported that there are approximately 100 million households in the U.S.

B) *Assuming that the $40 to $50 billion figure is correct, producing a "hidden tax" on every American family of $400 or $550 a year, can you estimate what portion of that amount actually could be recouped by the Bankruptcy Reform Act of 1999?*

I believe that a nationally representative Ernst and Young Study, presented to the House Judiciary Committee last year, estimated that approximately 10 % of the dollars now lost to bankruptcy could be recouped.

C) *Have the interest rates on Boscov's charge cards increased/decreased in the past in step with bankruptcy filings and losses that you have attributed to bankruptcy? If so, please document these changes.*

Boscov's credit finance charge rates were raised in early 1997. The increase was in response to increases in credit losses (primarily attributable to increases in bankruptcy losses). The percentage of Boscov's charge sales to total Boscov's sales has decreased every year for at least the last five years. This is partially attributable to the tighter lending practices we have been forced to pursue.

D) *Has the cost of merchandise at Boscov's increased/decreased in the past in step with bankruptcy filings? If so, please document these changes.*

The cost of merchandise at Boscov's is related to a tremendous number of variables (e.g. the cost of goods, the cost of money, shipping, labor, utilities and rent) including changes in bankruptcy losses. It is not possible to directly determine the net effect bankruptcy has on consumer prices.

8) *You testified that "everyone's credit is tighter" when people use the bankruptcy system as a means of walking away from their debts. Can you document that you restricted your lending, or that the industry generally restricted its lending as a result of the increase in bankruptcy filings?*

Boscov's implemented an on-going portfolio monitoring program in 1995 in direct response to increasing credit losses (primarily attributable to increases in bankruptcy losses). Through this program, Boscov's has closed or reduced the credit limit on tens of thousands of accounts, including accounts, which were not delinquent at Boscov's. This is the most aggressive limit management program Boscov's has ever implemented.

9) *Representing the National Retail Federation, you testified that the emergence of a new phenomenon, surprise bankruptcy filings, is an indication that bankruptcy is becoming a first step rather than a last resort. You said: "Today, we see a very different picture. Often the first indication we receive that an individual is experiencing financial difficulty is when we receive notice of his bankruptcy petition. . . . The first indication of a problem is the notice that they have filed for bankruptcy." In 1983, a representative of the National Retail Merchant's Association and American Retail Federation similarly testified that "a new and substantial class of debtors—one different from the traditional debtor—was also found. These persons were current on their required monthly payments, had little or no previous history of delinquency, and some even had additional credit available on the account at the time the bankruptcy notice was received by the creditor." See Statement of Raymond W. Klein, H.R. Macy & Co., Inc., representing the National Retail Merchants' Association and the American Retail Federation before the Senate Judiciary Committee Subcommittee on Courts (January 24, 1983). Are you identifying the same "new" phenomenon as Mr. Klein did in 1983? If not, how are they different?*

Although I do not have direct knowledge of the 1983 statement, I believe Mr. Klein saw the beginnings of the problem. What is new, in my experience, is the dramatic increase in the numbers of customers making the decision to file without being seriously delinquent with Boscov's.

10) *You testified that the system should be changed to incorporate means testing regardless of what percentage of individuals currently choosing chapter 7 actually*

could pay any of their debts. However, legislators need to have a better sense of how many chapter 7 debtors are solvent because it is relevant in determining whether the substantial change would be cost-justified. We first heard that industry funded studies predicted that one third of chapter 7 debtors could pay some or all of their debts. Later industry funded studies predicted lower and lower numbers, the latest being 11%. A recent non-industry study sponsored by the American Bankruptcy Institute found that the most optimistic number of chapter 7 debtors able to pay even 1/5 of their debts over 5 years is under 4%, and that the amount of dollars the credit industry will recoup directly from this change is likely to be a fraction of the industry's estimate.

The number of persons who it is estimated can repay their debts keeps changing because Congress keeps changing the standards in the proposed needs based system. Earlier versions of bankruptcy reform proposals were directed at bankruptcy filers earning more than 75% of the median income and who could repay 20% or more of their debts, thus a higher percentage of repayment capacity was properly reported. More recent reform proposals have restricted the needs based formula to those filers who are at or above the national median income and who could repay more than 25% of their debt. Accordingly, a smaller repayment capacity was reported. (As to the 4% figure contained in the American Bankruptcy Institute study, I also understand that ABI used old data.)

A) *Approximately what percentage of chapter 7 debtors do you believe can repay a substantial portion of their debts?*

Under the current needs based reform proposal (H.R. 833), we believe approximately 10% of Chapter 7 debtors could repay a substantial portion of their debt.

B) *How many dollars you believe you will recoup from that system so that we can compare that to the cost to the taxpayers of the change?*

We believe repayment ability is approximately $4 billion per year.

11) *Most discussion has focused on the importance of the means test, which was the subject of the panel on March 11. However, various versions of the bankruptcy bill span 300 pages and contain hundreds of amendments affecting consumer bankruptcy. Would you be willing to accept a means testing amendment and forego the remainder of the other significant consumer bankruptcy amendments, such as the various provisions expanding the nondischargeability of credit card and retail charge card debt and the provisions inflating the value of nominally secured debt?*

Many of the provisions in the bill are inter-related. Provision such as consumer education, auditing, and changes designed to improve the system's operations and to diminish cheating and other abuses are all important to the proper operation of the bankruptcy system.

Sincerely,

DEAN E. SHEAFFER,
Vice-President—Director of Credit.

cc: Honorable George W. Gekas

BRUCE HAMMONDS' RESPONSES

SENATOR TORRICELLI'S QUESTIONS

Question 1.

We strongly support providing customers information that facilitates their wise use of consumer credit. Through account-opening documents, cardholder credit agreements, monthly account statements and annual transaction reports, bankcard customers are provided with an immense variety of account-related information presented in precise detail.

The Conference Report on H.R. 3150 of the 105th Congress did provide for new disclosure requirements related to minimum payments on account balances, which are different in form and detail to those in an amendment offered by Senator Durbin and contained in the Senate's bill. Our experienced judgement is that the Conference Report's format very effectively informs consumers of the implications of repaying a credit balance solely through minimum payments. It does so at considerably less cost than the Durbin approach, which we assume is an important and valid consideration.

The Conference Report also directed the Federal Reserve Board to conduct a highly comprehensive study of consumer use and understanding of minimum payments, to report its findings to the Congress, and to use its extensive regulatory authority

under the Truth In Lending Act to promulgate such additional disclosure requirements as the study may deem useful.

Three decades of experience with the Truth In Lending Act has proven the wisdom and utility of using Federal Reserve studies (typically involving rigorous consumer testing) as the fact-finding foundation for new disclosure requirements. It would be ill-advised for Congress to statutorily impose a costly and burdensome scheme without allowing the Federal Reserve to fully evaluate it's impact on the industry and on consumer behavior.

Question 2.

There is no national data base reporting the annual credit losses attributable to the discharge of loan obligation by Federal Bankruptcy Courts in proceedings under Chapters 7 and 13. However, studies by nationally-recognized research organizations present findings which we believe have been carefully and soundly formulated.

SMR Research published a 1997 study estimating consumer bankruptcy system losses at $40 billion for 1996. The WEFA Group presented a report to the Senate Banking Committee in February of 1998 estimating losses for 1997 at approximately $44 billion. Also in 1998, Ernst and Young reached a similar (somewhat higher) estimate of total Chapter 7 bankruptcy debt to WEFA's estimate for 1997. The Ernst & Young analysis is based upon a statistically reliable national data base using 1997 bankruptcy petition data. Adjusting these very consistent findings for the growth in consumer bankruptcy filings in 1998 and the projections for 1999, it is reasonable to assume that losses from the consumer bankruptcy system for 1999 will approach $50 billion.

Question 3.

With over 7,000 financial institution competing in the credit card industry, it remains one of the most competitive industries in the U.S. As a result of that competition, profits from credit card portfolios across the industry have declined over the past 5 years.

As is true generally for the financial services industry, technology has fostered changes leading to greatly intensified competition among issuers of bankcards and credit cards. In the 90's, interest rates on card offerings have declined some 200 basis points, annual fees are nearly non-existent, reward and purchase-discount programs are widely available, and customer service has been dramatically improved. In this competitive environment, it is a certainty that a reduction in losses will translate into a variety of consumer benefits, including price reductions or improved product quality.

Question 4.

Using generalized historical experience in Chapter 13 under the existing provisions of the Code is not a reliable basis for predicting future performance under the system which will develop with the reforms proposed in H.R. 833 and S. 625. In a reformed system, the vast majority of the cases in Chapter 13 will be there because Chapter 7 will no longer be a legally-available alternative for relief.

The reasons for failures in Chapter 13 have not received sufficient systematic and statistically-valid analysis to justify broad generalizations. There is, however, extensive anecdotal experience to justify a conclusion that in many Chapter 13 cases a primary motivation is to preserve use of a secured asset (home or car) by curing arrearages and bringing cash flows into balance. Once that goal is accomplished, the economic incentive of remaining in Chapter 13 is significantly reduced. Some, at least, then proceed to Chapter 7 to eliminate unsecured obligations. Reform cuts off that option.

There are a few bankruptcy court districts in which the judge-created culture of many years has educated lawyers and debtors that Chapter 13 is a preferred alternative. In these districts the plan-completion success rate has been well above the national norms.

Question 5.

Members of Congress have the best "hands-on" understanding of the essentiality of compromise in accomplishing worthwhile reform. In today's setting, secured lenders enjoy generally satisfactory outcomes under Chapter 7. Both lender and debtor have incentives to reach reaffirmation agreement thus permitting the debtor's continued use of a valuable asset such as a car. Unsecured lenders more often than not get nothing. If a reformed system is to require debtors with demonstrated repayment capacity to seek relief in Chapter 13, where plans will require repayment of some portion of unsecured obligations, that reformed system must deal in a balanced manner with secured creditors. Providing reasonable protection from cram

down is a practical accommodation to the achievement of major improvements in the consumer bankruptcy system.

SENATOR GRASSLEY'S QUESTIONS

Question 1.

I categorically reject the notion that credit card lending is responsible for the dramatic rise in consumer bankruptcy filings!

The Federal Reserve's most recent *Survey of Consumer Finance*, released in January, 1997, reports that the total household debt held by all families credit card debt represents 3.7 percent of total indebtedness. To allege that this small segment of total consumer debt bears a principal responsibility for the rise in consumer bankruptcies makes no sense.

Unquestionably, the availability of credit to American households has expanded dramatically throughout the last half of this century. However, according to recent information from the Federal Reserve, the absolute level of consumer debt as a percentage of assets has remained at 5% *since* 1970. In short, debt, as a percentage of assets, has not increased over the past 29 years, which directly refutes the "explosion" of credit theory. Indeed, for the past thirty years this trend has been steadily intensified through the powerful influence of Federal statutory and regulatory mandates.

Moreover, public attitudes concerning the use of credit have undergone immense change. Certainly the use of credit by a steadily-growing segment of our population means the incidence of consumer bankruptcy will likely rise in some parallel relationship. *But making consumer and other forms of credit more broadly available to the general public, and particularly to discrete segments of our population previously denied credit, does not represent irresponsible, imprudent, or predatory lending. Legislation of the past twenty-five years has evidenced the desire of Congress that all segments of the public be served fairly and adequately. Restrictive legislation will cause denial of credit to those otherwise creditworthy borrowers who most benefit from the flexibility consumer credit provides.* For example, the rate of bankruptcy filing in Memphis, TN is 33% higher than the national average. For credit cards to be the sole link to bankruptcy, resident of Memphis would have to have 33% more credit than the national average—and that simply is not the case.

Holding needs-based reform of our consumer bankruptcy system hostage to a debate over whether all consumer lenders behave prudently and responsibly simply misunderstands the purpose and the methodology of the proposed reforms. *Needs-based limitations on bankruptcy relief will not bail our bad loans. Where basic cashflow analysis demonstrates no reasonable capacity to repay the bankruptcy system will continue to discharge the debtors and the lenders will continue to bear the full responsibility for a bad loan. But, where repayment capacity exists to some considerable degree (25 percent OR $5,000, seems fair), then our Federal bankruptcy system should not randomly ignore and undermine sound credit underwriting practice. Bankruptcy system discharge policy cannot be at odds with consumer credit underwriting if we want our national economy optimally served by the lending industry.*

Question 2.

Our concerns are for the trends of behavior and practice and the long-term impact on future outcomes. Throughout the consumer lending industry (including retailers) we are encountering growing numbers of cases where customers with no history of repayment problems file for bankruptcy relief without notice.

Ernst & Young, using a nationally-valid database of 1997 bankruptcy petition data and the income-expense guidelines of H.R. 833 and S. 625, concluded that 10 percent of all filers had incomes at or above the national median family income and could have repaid a significant portion of their unsecured obligations. This amounts to roughly 100,000 filers. In our information-driven society of today, it would be naive for us to conclude that the bankruptcy system's treatment of 100,000 debtors or more annually is going unnoticed by the remainder of our national society. Clearly if we establish no reasonable standards for bankruptcy relief, if our courts ignore capacity to repay—a treatment at odds with rational loan underwriting—we should expect growing numbers to avail themselves of such relief. At some point that upward trending development must be accounted for by lenders—probably first by pricing and/or diminished service, but ultimately by more restrictive availability. To protect against that future dilemma by directing the Federal bankruptcy system to adopt orderly procedures employing objective standards for determining the nature and extent of relief granted petitioner would seem to be both reasonable and responsible.

SENATOR FEINGOLD'S QUESTIONS

Question 1.

Note: Since bankruptcy losses were not available for 1980, 1989 was used for comparison purpose.

1(A) Ending outstanding for calendar year 1989 and 1990 were $5.1 billion and $48.7 billion, respectively, and average outstanding for 1989 and 1998 were $4.5 billion and $45.3 billion, respectively.

1(B) In 1998, non-bankruptcy losses were $1.1 billion as compared to 1989 non-bankruptcy losses of $46 million.

1(C) MBNA's bankruptcy losses as a percent of credit card debt outstanding in 1989 and 1998 were 1.02% and 2.61%.

1(D)

	1980	1998
A. Average Balance per Active Account (1998 Dollars)	$1,058	$2,339
B.	n.a.	2.9% of outstandings
C.	n.a.	2.9% of outstandings

Question 2 A.

The Federal bankruptcy system does not maintain an annual accounting of the aggregate amount of consumer debt discharged. The WEFA Group, a highly regarded national economic consulting firm, used established econometric and evaluating methods to produce it loss estimate from bankruptcy petition data. Two other outstanding economic research organizations, SMR Research and Ernst & Young, conducting independent studies using different data bases, produced conclusions of aggregate consumer bankruptcy debt and losses comparable to WEFA's results.

GAO did not characterize WEFA's figures as "unreliable". With respect to the GAO's comments on the WEFA study, I respectfully recommend a careful review of WEFA's response, dated April 29, 1998. Acknowledging that all bankruptcy studies to date have used unaudited petitioner data (since neither the courts nor the U.S. trustees conduct audits), I believe WEFA carried out its evaluation with great professional integrity and utilized established methodologies in arriving at its quantitative conclusions.

Question 2 B.

While I did not use a $550 per household average for 1999, the estimate of projected losses for this year in a general magnitude of $50 billion does not seem unreasonable.

Questions 2 C and 2 D.

My understanding of the WEFA, Ernst & Young, and SMR loss estimates is that each endeavored to calculate aggregate losses arising from discharge. If my understanding is correct, the estimates do not take account of reaffirmations, non-discharged obligations, and "failed plans" in Chapter 13, which means that the estimates are conservative.

Keep in mind that most filers choose Chapter 7 and unsecured lenders typically collect nothing in a Chapter 7 filings. In 1997, according to Ernst & Young, using the only statistically valid bankruptcy petition database in existence, total unsecured debt in Chapter 7 approached $35 billion.

Question 2 E.

The estimate o floss does not include so-called contract charge-offs that occur outside of the bankruptcy process and which are largely governed by the financial regulatory agencies' guidelines.

Question 3.

In fact, the intensified competition within the bankcard industry over the last few years has materially influenced pricing and product content. Interest rates are down some 200 basis points, annual fees are essentially non-existent, and product enhancement (rewards, discounts, 24-hour customer service) continues to expand.

Among traditional bank loan products, funding cost are least influential for pricing purposes in unsecured bankcard lending. Among the large issuers, funding costs are typically 40 percent or less of total expenses. The remaining 60 to 70 percent is comprised of servicing, general administration, marketing, and loan losses. Cur-

rently in our expense base, funding and loan losses each represent about one-third. Over traditional economic cycles, there is usually a strong reciprocal dynamic relationship between funding costs and loss-related cost:—when one factor is up the other is down. This offsetting relationship makes it hard to predict pricing practice based on the level of market interest rates.

While I'm reluctant to be highly specific in publicly sharing proprietary data, I will state that the percentage of our annual credit losses attributable to bankruptcy discharges has risen very substantially in the last few years. Moreover, as I indicated in my testimony at the Senate-House hearing, a majority of our bankruptcy charge-offs occur in accounts that have been with us for three or more years. These are accounts that were carefully underwritten at their inception and for which we have extensive experience data for account administration.

Since the increase in bankruptcy has driven loss rates to unprecedented levels. MBNA has implemented strategies which increase APRs on accounts bases on risk. This strategy, while necessary to maintain profitability, has resulted in customers receiving APRs of at least 23.9% in some circumstances. Previously, APR increases on the portfolio were typically associated with changes in cost of funds.

Question 4.

Of course bankruptcy-related losses (like other losses) impact the behavior of individual lending institutions. Because the aggregate volume of consumer credit in our national economy has grown since 1980, it does not follow that this result was unaffected by the bankruptcy losses sustained over this two-decade period. The varying experience of individual institutions and the multiplicity of other economic, regulatory, technological, cultural, and other factors which have shaped lending decisions make it impossible to isolate the precise impact of bankruptcy losses. But have no doubt that all major cost components directly influence each lender's decisions on the key considerations of price, availability, product content, service, and marketing.

Restriction of credit is one way to maintain profitability in the face of rising losses. MBNA Has not yet restricted credit, because we have been able to offset higher losses through more targeted pricing strategies. However, deteriorating credit quality of applicants has led to lower approval rates. If losses continue to increase, ti will be difficult to maintain profitability by increasing the interest rate charged to the consumer. If revenue cannot be increased through repricing, restriction of credit would be necessary to reduce losses.

Question 5 A.

MBNA doe s not approve credit for recent bankrupts. In select circumstances, MBNA may approve credit for a former bankrupt, if we are able to establish that the consumer has resolved the situation that led to the bankruptcy and has also established a track record of repayment with other creditors.

Question 5 B.

Most major bankcard issuers evaluate applications based on an overall risk profile that is designed to yield loss rates that track at or below the industry average. Because most former bankrupts would not fit this profile, they would be declined for an account if they responded to a mass-market solicitation. However, some issuers do target riskier prospects and compensate for the increased risk through security deposits, higher interest rates, and fees. Certainly if the concept of "fresh start" has practical meaning, it is to be expected that many individuals and households will need access to credit and the opportunity to rebuild their credit records through responsible management of their financial affairs.

Question 6.

6(A) In 1998, MBNA challenged the dischargeability of the debtor's debt on less than 1% of the total Chapter 7 petitions filed, almost all of the basis of fraud.

6(B) Of the cases where dischargeability was challenged, 6% (of the 1% described above) were litigated. However, response is still pending on 71%, so the litigation percentage could potentially increase.

6(C) 93% of debtors either admitted non-dischargeability or reaffirmed their debt. This is the case because MBNA rarely challenges any petition except for fraud. When confronted with their attempt to propitiate a fraud on the court, the overwhelming majority decide to choose another option, i.e., repayment.

Question 7.

Over the past thirty years there has been a tremendous broadening of the availability of consumer credit within our national society. Federally mandated statutory and regulatory policy has been a powerful force in support of this development. This

so-called democratization of credit availability is strongly favored by the public. There has been corresponding cultural change in terms of public acceptance of credit use. Lenders have responded to these dynamics of public policy and public attitudes. To state the obvious, if many more individuals and many more households have access to credit (which they do), it follows that within that expanded population of credit users there will be, at least, a normal incidence of bankruptcies, which will increase the absolute numbers overall. Lenders share in the responsibility for that increase to the extent that underwriting makes bad choices and individuals cannot meet their credit obligations. In that circumstance lenders bear the loss, as they properly should. Losses stemming from a debtor's cashflow incapacity to pay are the assumed risks of consumer lending. Proposed bankruptcy reform initiatives are not designed to and WILL NOT provide relief to institution for losses which are the result of underwriting errors.

Solicitations, by mail or telephone, or credit card offerings are modes of marketing; no different in content or purpose than advertising in newspapers or on radio, TV, and the Internet. The volume of solicitations is a direct reflection of the intensity of the competition that exists within this sector of the financial services industry. While direct-mail solicitations may prove irritating to some, they certainly pose no threat to our economic health, and these solicitations bear no more responsibility for the frequency of bankruptcy than automobile advertising does for traffic deaths.

Question 8 A.

Yes, and when we're wrong, we should (and will, even under proposed legislation) bear the resulting losses. But when our underwriting has correctly predicted ability to repay, as demonstrated by the petitioner's own bankruptcy petition calculations, the bankruptcy system should not discharge the obligation. If this practice continues, new assumptions will need to be built into our underwriting that will restrict credit to creditworthy consumers, with predictable consequences not only for many thousands of consumers, but also for the U.S. economy.

In terms of all of those who look to us for responsible behavior (customers, shareholders, employees, and regulators), we have no higher obligation than to make our best efforts in underwriting credit extensions, which entails identifying individuals who will use credit prudently and who will fulfill their contractual repayment obligations. While technology is expanding and improving our underwriting capabilities, it is in no sense a perfect science. In our own procedures we continue to place heavy reliance on the direct review of credit applications by experienced underwriters.

Question 8 B.

An overwhelming majority of those who file for bankruptcy—almost 75%—have a serious disruption in income in the year prior to filing. As a result, a large number of filers who were prudently granted credit—and who prudently used credit—turn to credit cards in an economic crisis, in an effort to maintain a lifestyle or to get back on their feet. Most are successful, with credit cards providing assistance. Those who are not successful show up in bankruptcy court with higher than average credit card debts. To the extent that they cannot repay their debts, they should be entitled to a discharge.

In consumer credit underwriting there is a mutual dependency of all credit grantors on knowledge of the activities of other grantors. We look to credit reporting agencies for information concerning the credit history of individual applicants. These national agencies are making great strides in perfecting the accuracy, currency, and comprehensiveness of their data. Nonetheless, these systems, which are likewise dependent upon periodic inputs from hundreds of thousands of entities, are not an absolute guarantee of accurate and up-to-date information. As a practical matter, there are simply too many variables to achieve systems that are error-free. Lack of currently reliable information is certainly one factor in the multiple card cases. Low-limit cards to individuals with limited credit history is another factor. And although we wish it were otherwise, consumer lending still suffers from some isolated cases of mediocre underwriting. However, given that as an industry 96% of our accounts meet their contractual obligations, I personally take great pride in the professionalism and responsibility of the American bankcard industry.

Question 9 A.

This quoted observation is not directed at the bankruptcy system's current lack of standards and systematized procedures for determining the relief needed by petitioners. It refers to the fact that the system does not provide training in the fundamentals of household financial management for individuals who have been through bankruptcy. We applaud the fact that last year's conference report, as well as legislation introduced this year, authorize pilot programs for this purpose. We in

the financial services industry are working at consumer education, and we will continue to expand and improve those efforts.

Question 9 B.

We believe that the new disclosure requirements relating to the use of minimum payments contained in the Conference Report on H.R. 3150 would do an effective job of alerting consumers to the financial disadvantages of using minimum payments as the principal means of repaying indebtedness. However, for those who believe more detail is necessary, the Conference Report directs the Federal Reserve Board to make a detailed study, to report its findings to the Congress, and to promulgate such additional disclosures as it deems beneficial. Thirty years of experience under the Truth In Lending Act has richly demonstrated the wisdom of using the Federal Reserve as the fact-finding instrument in the development of comprehensible disclosures that can be provided in a cost-effective manner.

Question 10 A.

Organizing the procedures of the Federal bankruptcy system to receive and review petitioner income and expense data and to apply the statutory expense guidelines represents a very straightforward information systems project involving routine systems applications. Once that systems structure is installed, its operation should prove both time and cost efficient to the entire process. Clearly it will be more orderly, efficient, auditable (and thus accountable) than existing arrangements.

Question 10 B.

If to repay 20% of a petitioner's outstanding unsecured debts over a five-year period required the petitioner to make monthly payments which were "overwhelming as compared to her disposable income", it is highly improbable that such a petitioner will be impacted by the needs-based test. The provisions have been crafted to protect against the very outcome suggested in this question. While it may be possible to construct a hypothetical example of a debtor with income at the poverty level being required to make repayment, in practice such a debtor will be unaffected by the needs-based reforms.

Question 10 C.

The IRS expense categories appear to cover most, if not all, of the expenses you inquired about. Specifically, the "other necessary expense" categories identified by the IRS cover health care, child care, and dependent care for the elderly invalid or handicapped. Thus, an elderly person filing under Chapter 7 would not need permission to include such expenses, but would be granted such expenses automatically.

Question 11 A.

My understanding is that there was technical mistake in H.R. 3150 which might have produced the result you suggest. However, I'm advised that error was corrected in the text of the Conference Report. In the unlikely circumstance that a required monthly repayment was too small to justify the administrative fee of the Chapter 13 trustee, that can be cured with some type of de minimus rule.

Question 11 B.

It is my understanding that trustees apply an approved overhead percentage to the administration of their entire caseload, rather than a monthly dollar amount. Accordingly, the larger repayment plans do and will continue to subsidize the administration of smaller plans.

Question 12.

Yes, I disagree with Ms. Miller's view. The Ernst & Young study of last year and its recent update (responding to legislative changes) demonstrate that there is a small but significant percentage of filers who have debt repayment capacity and should be obtaining their bankruptcy relief in Chapter 13.

Question 13 A.

The 16% figure was presented in the 1997 study of Professors Michael Staten and John Barron, published by the Credit Research Center, affiliated with Georgetown University.

Question 13 B.

The 16% figure includes only bankcard debt, which is all unsecured.

Question 13 C.

The Staten-Barron study estimated all credit card debt (including bankcard debt) in the total credit obligations of Chapter 7 and Chapter 13 debtors to be 28% of the total.

Question 14.

Since bankcard debt represents roughly one-sixth of the total credit indebted ness of debtors in Chapter 7 and Chapter 13 (according to estimates of Staten and Barron), it is a little difficult for me to understand how bankcard debt becomes a "disproportionate" part of the overall debt problems of these petitioners.

Question 15 A.

According to the study conducted by Ernst & Young, it concluded that for 1997, under the needs-based system in last year's Conference Report, debtors could have repaid some $3 billion over five years.

Question 15 B.

In 1998, contractual losses were $1.1 billion.

Question 15 C.

Most charged-off loans are sold at discount to firms that specialize in the collection of defaulted obligations.

For accounts in delinquency, MBNA utilizes telephone calls, statement messages, and direct mail to open communications with delinquent customers. Once a customer is contracted, a variety of payment options are available, for example, electronic debiting of customer deposit accounts, fixed payment options, reduced interest (in conjunction with CCCS referrals), and offers of settlement for less than the full amount of principal.

Question 16.

No! Both the House and Senate bills in the 106th Congress include many provisions that have the potential for significantly improving our bankruptcy system, and, hopefully, over time creating conditions in which consumers who suffer life events producing financial disruption will look to credit counseling and other alternatives short of bankruptcy. It would be unfortunate not to begin putting in place all of these reforms, many of which will be most effective when working as part of an integrated whole.

Question 17.

My own prioritizing would be as follows : (1) custodial parents, (2) obligations to governmental entities, (3) secured creditors, (4) unsecured creditors including card issuers.

Question 18.

The two debts should not and *are not* treated the same under either current law or proposed reform. Non-dischargeability in such cases is only a presumption which may be overcome by demonstrating a legitimate reason for obtaining the credit. I am not aware of any court which would not view the purchase of food and fuel as legitimate. By the same token, I would hold that the law would not condone the obtaining of credit without an intent to repay for luxury good and services or frivolous activity such as gambling.

On a purely personal basis, the mother's case is clearly the most appealing. In fashioning public laws and implementing regulations one must, of course, be attentive to the practical problems of enforcement and the associate requirements of proof. With cash advances, money being fungible, it is difficult (perhaps impossible) to determine the precise use of any particular cash advance. Therefore, for cash advances the practical approach is to establish limits on discharge based on timing and amount. I believe this is the approach in existing law.

Question 19.

I find the premise for this question troubling. I hope there is no intention to place bankruptcy reform in a partisan political context. All of us who have worked in support of these legislative reforms have been pleased by the support, cooperation and encouragement we have received on both sides of the political aisle. It has been particularly pleasing to note that in this Congress both the House and Senate bills have had as their original co-sponsors prominent and respected Members of Congress from both political parties.

Question 20.

Last year's Conference Report includes a number of new creditor obligations. Even though some are not necessarily relevant to consumer bankruptcy, it does seem to me that a sound balance was achieved, which I accept as fair and necessary.

JUDGE CAROL J. KENNER'S RESPONSES

U.S. BANKRUPTCY COURT,
DISTRICT OF MASSACHUSETTS,
Boston, MA, March 23, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

Re: Followup Questions to the Senate and House Joint Hearing on Bankruptcy Reform

DEAR CHAIRMAN HYDE: Thank you for forwarding to me the followup questions of Senators Torricelli and Grassley. Their questions and my answers are as follows:

SENATOR TORRICELLI:

1. *Senator Torricelli first asked whether, based on my experience, Congress's intention of providing meaningful debt relief in Chapter 7 for honest, hard-working, middle class American families was best served by the current policy of not requiring bankruptcy courts to review reaffirmation agreements (except where the agreement is not accompanied by a statement from the debtor's attorney) or by the earlier policy, contained in the Bankruptcy Code as it existed in 1983, mandating court review of all reaffirmation agreements.*

Based on my experience, I believe that Congress's intention is better served by the earlier version of the law, which required court review of every reaffirmation agreement. This is the only means by which raffirmation agreements can uniformly get the independent review that the Bankrtupcy Code now attempts to obtain (in most instances) from the debtor's attorney, with extremely mixed results. The importance of independent review may be heightened if additional provisions are added to the Bankruptcy Code that increase the leverage of some creditors to obtain reaffirmation agreements. (See response to Question 2.)

2. *Senator Torricelli's next question was this: in view of my testimony—that some debtors reaffirm debts after being accused by credit card companies of having committed acts that make those debts nondischargeable, whether or not they are guilty, because they cannot afford to defend themselves in a court proceeding—what will be the effect of adding more execeptions to discharge that make it 3easier for credit card companies to argue that their debts are nondischargeable?*

The likely effect would be to increase the leverage of credit card companies to obtain reaffirmations agreements, even from honest debtors. Credit card companies presently rely heavily on the ecxception from discharge for fraud and misrepresentation, 11 U.S.C. section 523 (a)(2)(A). Their complaints typically allege that the debtor incurred credit card debt without truly intending to repy the debt: a fraudulent misrepresentation of intent to repay. These cases almost always boil down to subjective judgments of intent, made on the basis of circumstantial evidence: we rarely have direct evidence of what the debtor was thinking when he or she incurred debt. Because the applicability of the exception turns on a judgment call, (1) the creditor can plausibly allege that exception applies without carefully looking into the cirmsumstances of the case, (2) resolution of the complaint is more costly because it requires litigating a disput of fact, and (3) even the honest debtor cannot be certain that the Court will ultimately read the circumstantial evident in the Debtor's favor. Thus, the uncertainty of the standard gives the creditor easy leverage over honest and dishonest debtors alike, leading many honest debtors to concede nondischargeability or to reaffirm the debt. The proposed amendment to section 523 (a)(2), set forth in section 310 of S. 625, would expand the presumption of nondischargeability for certain credit card debts. The presumption would further strengthen the hand of credit card companies.

3. *Senator Torricelli's final question is whether I would agree with the suggestion that the recent successful prosecution of certain consumer creditors for widespread illegal reeaffirmation practices demonstrates that "the system works," such that review of the reaffirmation process is not necessary.*

I disagree with this position for reasons I set forth in response to Senator Grassley's first question below.

SENATOR GRASSLEY:

1. *Senator Grassley's first question concerns the problem of debtors being coerced into reaffirmation agreements by abusive or deceptive creditor practices: given the laws and harshsanctions that are already in place for dealing with such conduct, why shouldn't we conclude that what we need is betyter encofrcement of existing laws, not new laws?*

Senator Grassley's concern about the probelm of illegal practices is valid. His empahisis on enforcement of existing laws is also well-warranted. My own experience with illegal creditor practices, however, is limited to the recent Sears case, to which the Senator's question makes reference; and, as a matter of judicial ethics, I am not at liberty to comment upon that case. Nonetheless, I can and would like to clarify that the subject of my tesitmony before the joint committees did not concern conduct that is illegal. Rather, my concern was and is with tactics that, though they fall within the bounds of the current law, nonetheless may intimidate debtors into uniformed and ill-considered decisions to reaffirm.

The Bankruptcy Code deals with the problem by mandating a third-party review to protect debtors from the imprudent decisions they make, often (but not always) under pressure from overbearing creditors. As I explained in my intiial statement, because this review is most often performed by the debtors' counsel, who have something of a conflict of interest when asked to be independent judges of what their clients propose, ti oftem doesn't result in a meaingurl review at all. Out of loyalty to their client, many attorneys simply facilictate the client's decision to reaffirm by providing the necessary declaration.

In essence, this is a case where the policy—the requirement of an independent review—is correct but the enforcement inadequate. To provide the necessary enforcement, the Code should be changed to require that a mandatory, non-waivable review be performed by the bankruptcy judge in every instance.

2. *Senator Grassley's last question concerns the effect on the Bankruptcy Court's workload of my proposal for court review of all reaffirmation agreements. He asks (1) whether I have considered how my proposal would affect the staffing formula used by the Judicial Conference to determine whether to request the creation of additional bankruptcy judgeships and (2) whether I have run my proposals by the relevant committees of the Judicial Conference.*

I have not considered how the proposals would affect the staffing formula, whether independently or in the context of the other amendments in H.R. 833. Nor have I run my proposal by any committee of the Judicial Conference. The increase in the workload would vary from judge to judge and would depend on the procedures and mechanisms developed—in the Code and Bankruptcy Rules, in the local rules of the various districts, and by individual judges—to facilitate the review. I believe the additional work that would be required to carry the proposal into effect is well-justified by the need to ensure to debtors the full benefit of their discharge. The additional work can be minimized by a requirement (along the lines of those in the Truth in Lending Act) that reaffirmation agreements clearly state to debtors the full cost over time, in principal and finance charges, of their reaffirmation, so that debtors and the court can more readily balance the costs and benefits of each agreement.

If I can be of any further assistance, please do not hesitate to contact me.

Sincerely,

CAROL J. KENNER,
U.S. Bankruptcy Court,
District of Massachusetts.

LARRY NUSS' RESPONSES

CREDIT UNION NATIONAL
ASSOCIATION, INC.,
Washington, DC, March 30, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CHAIRMAN HYDE: I am responding on behalf of Larry Nuss of the Cedar Fall Community Credit Union, who appeared before the Joint Hearing of the House Sub-

committee on Commercial and Administrative Law and the Senate Subcommittee on Administrative Oversight and the Courts to testify on bankruptcy reform on March 11. I wish to extend our thanks for agreeing to keep the hearing record open an additional week to provide the opportunity to answer the additional questions provided to Mr. Nuss. His answers, as the witness for the Credit Union National Association (CUNA), are attached.

Sincerely,

GARY J. KOHN, *Vice President & Senior Legislative Counsel.*

Enclosure

ANSWERS TO SENATOR TORRICELLI'S FOLLOWUP QUESTIONS:

Does it bother you that the lending practices of large for profit lenders are increasing your losses? Do you think you deserve better treatment in bankruptcy because you at least are trying to lend only to those people who are more likely to be able to repay?

In most case situations where our member files for bankruptcy relief, we find that the member has taken on more credit than they are able to repay on a systematic regular basis. We will attempt to work out a repayment schedule that will assist the member in making regular payments on their debt. We will analyze the annual percentage rates to determine what debt we can consolidate in order to reduce the member's total finance charge. If the member has equity in a home we will counsel the member emphasizing that they are pledging their home to consolidate debt before finalizing a consolidation loan. In many cases we are able to reduce their interest rate to half of the rate they are paying on unsecured debt. We also determine if they have equity in an automobile and consolidate debt into the auto loan, again reminding them that an auto will require replacement some time in the future. When we are able to consolidate members' debt, we request that they not respond to any other offers that they may receive in the mail or by telephone. Our philosophy is to evaluate each member's request on its own merits. A member must request an increase in secured and unsecured debt. We do no automatically increase a members line-of-credit like so many creditors practice. We feel that members have a tendency to reaffirm with the credit union because of our member-owned cooperative structure. They also recognize that they will continue to have a need for financial services. For many years our credit union has maintained a low net charge-off ratio in spite of a delinquency ratio that was above peer group comparisons, we feel these ratios exemplify the fact that we attempt to "work out" a satisfactory repayment of debt that not only helps the credit union but also restores the self-esteem most members have and we think this is very important for the members, if the credit union did not receive reaffirmations, it would have a major impact upon the credit union's capital structure.

ANSWERS TO SENATOR GRASSLEY'S FOLLOWUP QUESTIONS:

How much has the Cedar Falls Community Credit Union lost due to bankruptcy filings?

	Amount	Percentage of total charge-offs
1998:	$34,813 =	51.8%
1997:	$40,237 =	38.5%
1996:	$39,353 =	58.6%
1995:	$19,848 =	35.0%

Could you comment on how many Chapter 7 cases you encounter versus the number of Chapter 13 cases you encounter?

	Number of filings	
	Chapter 7	Chapter 13
1998:	18	1 converted to Chapter 7
1997:	24	2
1996:	21	4
1995:	17	0

SENATOR RUSS FEINGOLD'S FOLLOWUP QUESTIONS AND ANSWERS:

1. *You report in your testimony that National Credit Union Administration data show that credit unions had approximately 253,000 members file for bankruptcy in 1998, an increase over the 250,000 filings in 1997.*

A) *What was the total number of members in the credit unions that were the subject of the NCUA statistic in 1998 and 1997, and the percentage of credit union accounts in bankruptcy in those two years?*

Before answering the question, let me first correct the record. The testimony indicated that the number of member bankruptcy filings were according to the NCUA. These estimates are, in fact, from CUNA's own research department. The estimate is, however, based on NCUA data, but because privately insured credit unions do not report to the NCUA, the agency's data is incomplete.

In 1998, CUNA estimates that the total number of credit union member was 76.1 million, while in 1997 the estimate is 73.5 million. We do not have statistics for the percentage of credit union accounts in bankruptcy. We do know that the dollar amount of loan balances subject to bankruptcy, as a percent of total balances was 0.40 percent in 1998 and 0.48 percent in 1997.

B) *Unless credit union membership declined significantly in 1998, a 3,000 increase in credit union member bankruptcy filings in 1998 (just over a 1% increase from the previous year) is probably far below the nationwide filing rate increase. Do you attribute this lower increase to self-correction in lending and/or the high standard of care generally used by credit unions when lending to their members?*

The credit union percent increase in bankruptcy filings is lower than the national percent increase. The lower rate of credit union increase could be attributable to many things. For instance, compared to national averages, credit union households are more likely to be two-income households and thus may be less exposed to shocks related to job loss, etc. Likewise, credit union field of membership policies may keep increase in check. Also, in 1997, the growth rate in revolving credit nationally was 5.5 percent. In contrast, the growth rate in credit union personal unsecured loans was –3.5 percent and +1.6 percent for credit card balances. There is a strong correlation, as indicated in other testimony, between growth in unsecured credit and bankruptcy filings. The slower growth in credit union unsecured credit may have something to do with stricter underwriting, but it is difficult to substantiate.

2. *You report that the Credit Union National Association estimates that almost half of all credit union losses in 1998 were bankruptcy-related and that those losses reached $684 million.*

A) *Does this mean that the bankruptcy losses are $684 million or the total losses are $684 million?*

The $684 million figure is for bankruptcy losses, not total losses. The calculation is based on the following: dollar amount of total loans (CUNA estimate) × net chargeoffs as a percent of total loans (preliminary call report data from NCUA) × percent of net chargeoffs due to bankruptcy (preliminary call report data from NCUA). That is: $254.2 billion × .0057 × .472 = $684 million.

B) *To enable us to determine the overall credit union default rate and bankruptcy default rate, what was the aggregate loan portfolio of all credit unions included in these statistics?*

As of year-end 1998, total loans were $254 billion, while total loans at year-end 1997 were $238 billion.

3. *According to your testimony, your credit union currently has 8,300 members. In 1998, 18 of your members (approximately .02%) filed for bankruptcy. The filing rate among your membership is far lower than the national filing rate. Although the national nonbankruptcy filing rate has increased substantially since 1995, your filing rate in 1998 (approximately .02%) is the same as in 1995 (assuming you had 8,300 members then as well).*

A) *To verify that your filing rate was approximately the same in 1995 as it is in 1998, how many members did you have in 1995?*

Our credit union had 6.031 members on December 31, 1995. On December 1, 1995, we had a single employee group credit union merge with Cedar Falls Community Credit Union with the merging credit union increasing our membership total by 840 members. The merging credit unions's sponsor had announced that they were going to be closing their Waterloo manufacturing site and moving their members would be better served by merging with another

area credit union rather than attempting to convert to a community charter on their own.

B) *Do you think that if other lenders were as careful as you are, that the market would fix the current "bankruptcy crisis" without the proposed government intervention?*

Probably not. We are concerned that conservative lending practices may not the entire answer to increasing bankruptcy filings. While credit union growth in bankruptcy filings was slower than the growth observed nationally, the level of bankruptcy filings amongst credit union members remains near all time highs. Over the past 10 years, total borrower-bankruptcies at credit unions have increased 82 percent. In that same period, credit union membership increased by only 26 percent. But the nation has experienced a positive economy for an extended period of time and what will be the rate of filings may very likely increase further. Credit unions may be more "careful" lenders than others, but many factors contribute to the growth in credit union borrower-bankruptcies, and more often than not they are factors out of credit union's control. Certainly, increased consumer financial education could be a great help; thus CUNA's increased efforts in this area.

C) *Although your filing rate is nearly identical in 1998 to your 1995 rate (assuming that the number of members has not changed substantially), your losses appear to have increased from $19,848 in 1995 to $34,813 in 1998. If you adjusted your numbers for inflation and reported your 1995 losses in 1998 dollars, how would your losses compare in those two years? If there still is a substantial difference, what accounts for that difference in losses?*

In comparing the 1995 loss total to 1998 losses after allowing for inflationary adjustments, the loss comparison would seem to indicate an increase in the amount being charged-off. If some of the members filing for bankruptcy under Chapter 7 did not reaffirm their debt, the losses would be substantially increased. For those members that filed Chapter 7, the ease of avoiding debt contributed to the increase in adjusted charge-offs.

4. *The losses in dollars that you experienced in 1998 that you have attributed to bankruptcy are only .014% of your loan portfolio. Does this extremely low dollar loss rate, along with your low filing rate, provide further evidence that bankruptcy losses can be contained by the market without unduly restricting credit availability overall?*

The bankruptcy ratio experienced in 1998 and the low percentage to our entire loan portfolio is indicative of a conservative lending philosophy established by our Board of Directors and lending staff.

5. *You testified that reaffirmation agreements have been a significant factor in reducing your losses.*

A) *How many of your bankrupt members reaffirmed one or more debts to your credit union in 1997 and 1998?*

We had nine member reaffirm in 1997 and another ten reaffirmed debt in 1998.

B) *What proportion of those reaffirmations was for partially secured car loans?*

1997—Six reaffirmed auto loans
1998—Eight reaffirmed auto loans
1997—Two reaffirmed a combination of auto and unsecured
1998—Two affirmed a combination of auto and other
One did not reaffirm but continued to repay on an auto

C) *What proportion was for credit cards or other unsecured debts?*

1997—Two reaffirmed a credit card
1998—One reaffirmed a credit card

D) *What was the total dollar amount of debt that your members reaffirmed in 1997 and 1998?*

1997—$121,581.83
1998—$70,114.60

6. *Your testimony indicates that you believe that your reaffirmation agreements confer a benefit on the debtors who reaffirm those debts. As you know, you may be one of several lenders asking a debtor to reaffirm her debts, and it may be financially infeasible for that debtor to honor all of those commitments. Reaffirmation of other debts may interfere with the debtor's ability to repay your credit union, and other*

lenders might use more aggressive collection practices and higher fees to encourage the debtor to pay them first.

A) *If debtors were not allowed to reaffirm any unsecured debt, would most of your members continue to pay you voluntarily?*

A very small percentage of member filing for bankruptcy do not complete a reaffirmation agreement but continue to pay. Our current policy regarding members causing a loss to the credit union simply states that the only service allowed is a basic share account allowing the member deposits and withdrawals. They are no permitted to have any other services being provided to the general membership but they can attend and vote at regular membership meetings. A reaffirmation agreement is identified as a commitment to repay which allows the credit union to extend other services to the member that has not yet cause a loss to the credit union and its membership. The lack of formal reaffirmation agreements would tend to lesson the debtors' commitment to repay some or all of the unsecured debt. Voluntary payment is fine, but we no recourse if they stop paying except to go after the collateral. We are prohibited from getting any deficiencies, otherwise known as a ride-through.

B) *Do you believe that the benefits your members receive from reaffirming debts to you would make them more likely to pay you than some of their other creditors?*

Again, the ability to have access to other financial services is a viable option many members feel is important. In addition, most members realize the commitment the credit union has to helping the member rebuild their credit status is recognized as a member benefit.

C) *Would you support court review of reaffirmation agreements if it did not necessarily require a hearing and could be done inexpensively?*

We would like to review any proposed structure of a court review of affirmation agreements but it is possible a viable program could be instituted. The caseload of the bankruptcy court system would be a challenge to this concept but we would be receptive to pursing the idea.

D) *Do you believe that reaffirmation agreements should clearly state the terms of the agreement so that debtors can understand the financial consequences of the reaffirmation, similar to the Truth in Lending Act requirements? If not, why not?*

When we discuss loans with our members we currently review all terms of the loan as required by the Truth-In-Lending Act. We certainly feel that debtors should get good information about their legal obligations and protections. But just as importantly, we feel that financial education and the understanding of finance is lacking. Education and counseling should be key factors to be considered when helping debtors understand the financial consequences to reaffirmation.

7. *You testified that you support needs based bankruptcy, in part because you believe that more of your members could repay some of their debt in Chapter 13. However, the national statistics on Chapter 13 plan completion are low, and many do not distribute much, if any, payments to unsecured creditors.*

A) *Of the Chapter 13 cases your members have filed since 1995, how many were completed or still in payment?*

Two Chapter 13's remain in payment.

B) *How many dollars of unsecured debt have been collected from in the Chapter 13 cases of your members since 1995?*

$8,854.49 of a total of $27, 479.71.

C) *If one of your members files for bankruptcy, are you better off financially if the member files for Chapter 7 and reaffirms her debt to you in full rather than filing for Chapter 13 and paying all of her debts pro rata over several years?*

The Chapter 13 experience has been with secured loans in almost all cases. One member remained in Chapter 13 for several months with the case being terminated. We were unable to consolidate the member's loans at the credit union and assist them in purchasing a more reliable auto for family usage. Another member converted a Chapter 13 to Chapter 7 but reaffirmed with us. The loan has since been charged-off due to the termination of her employment. Two Chapter 13 filings have continued to pay full loan payments via payroll deduction and a third has continued to pay contracted payments directly to the credit union. Another Chapter 13 was charged-off because the member moved to Texas

and we have never received a payment on the contracted loan. Based upon our experience, a Chapter 13 filing in cases where the member has the ability to pay at lease some of the debt is more beneficial to the overall membership than simply charging the balance against the reserves.

8. *Most discussions have focused on the importance of the means test, which was the subject of the panel on March 11. However, as Gary Klein pointed out at the hearing at which you testified, the bankruptcy bill spans 300 pages and contains hundreds of amendments affecting consumer bankruptcy that have received little or no attention. Would you be willing to accept a means testing amendment and forgo the remainder of the other significant consumer bankruptcy amendments, such as the various provisions expanding the nondischargeability of credit card and retail charge card debt and the provisions inflating the value of nominally secured debt?*

Means testing is an important cornerstone of reform. Without knowing specifically what all the "significant consumer bankruptcy" amendments are, we are unable to comment on this proposal.

9. *In recognition of the lower loss rates and sometimes more responsible consumer lending practices of credit unions, should there be special provisions in this legislation that apply only to credit unions? Should credit unions be treated differently with respect to reaffirmation?*

Credit unions shouldn't be prevented from obtaining reaffirmations, since there is no indication that they have any problems in that area. Our members, as consumers, should retain the right to choose which debts, or whether, to reaffirm.

10. *Do you believe there are any creditor abuses in the bankruptcy system that should be addressed in bankruptcy reform legislation? If so, what are they?*

We are aware of the illegal practices in reaffirmations in the Sears and other cases. As mentioned in my testimony, they were punished under the current code and the size of the penalty should act as a deterrent for future abuses.

GARY KLEIN'S RESPONSE TO SENATOR TORRICELLI'S FOLLOWUP QUESTIONS

Question: We have been told in the past that there is a difference between provisions that are "debtor friendly" and those that are "consumer friendly". For example, some people have argued that provisions protecting the fresh start for honest families work hardship on other consumers who never file for bankruptcy. And, on the flip side, we have been told that by restricting debtors' rights, we will make the price of credit, goods and services cheaper for nonbankrupt consumers. As an advocate of both debtors and of consumers, can you comment on whether this distinction is real? Are the interests of bankrupt debtors and middle class consumers conflicting?

Response: No. Organizations that represent consumers [National Consumer Law Center, Consumer's Union, and Consumer Federation of America] [1] unanimously believe that proposed bankruptcy legislation is among the worst bills for consumers offered in the past 20 years. Only the credit industry call this bill "consumer friendly".

EXPLANATION:

Bankruptcy cannot appropriately be blamed for credit industry losses that are passed on to consumers. All parties concede that the vast majority of debts written off after bankruptcy couldn't have been cost-effectively collected if bankruptcy had no intervened. "Bankruptcy losses" are really just "bad loan" losses. The problem for consumers is that the credit industry is too aggressively marketing loans to consumers that can't afford to pay their balance in full each month. The industry does this because, in the aggregate, those loans are profitable.

The banking industry has claimed that it is losing 40 billion dollars each year to the bankruptcy system and that it is passing those costs on to consumers at the rate of $400 per family. The unpublished credit industry-funded report which served as the basis for this claim has been criticized by the GAO for lack of analytical rigor.[2]

Families may be discharging debt in bankruptcy, but all of the relevant empirical work, including the creditors' own studies, agrees that the debtors involved can not afford to repay those debts. Most recently, a study released by the American Bank-

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[1] Representatives of each organization have reviewed and agree with this response.

[2] GAO/GGD–98–116R "The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan.

ruptcy Institute showed that only 3% of chapter 7 debtors can afford to pay back their debts.[3] A recent Ernst & Young study (funded by Visa) concludes that bankruptcy debtors can afford to pay back 10 billion dollars in debt, but they reached that conclusion only by including secured debt, non-dischargeable debt, and reaffirmed debt *which is not discharged in bankruptcy* and which must be repaid by chapter 7 debtors in any event.

In reality, the lending community is scapegoating the bankruptcy system for losses associated with its bad loans. If no bankruptcy system existed, it would likely cost the credit industry two dollars in collection costs for every additional dollar generated from the overwhelmed consumers that that now get relief in bankruptcy. The bankruptcy bill is, in part, an attempt to pass these collection costs on to taxpayers.

The problem could be fixed if lenders were more closely attentive to underwriting. Industry consultants estimate that credit card companies could cut their bankruptcy losses by more than 50% if they would institute minimal credit screening.[4] They choose not to make that effort because high-rate credit card lenders profit, in the aggregate, by finding borrowers that cannot afford to pay their balances in full each month. Since most of that debt is repaid at high rates, the industry profits despite increasing defaults and the attendant hardship to families.

There is no reason to think that any savings to lenders which would result from tightening the bankruptcy laws would be passed on to consumers.

There is no evidence that lenders would reduce rates on unsecured consumer lending if they could avoid bankruptcy losses. Between 1980 and 1992, the federal funds rate at which banks borrow fell from 13.4% to 3.5%. Nevertheless, credit card interest rates actually rose.[5] How likely is it that savings realized from changes in the bankruptcy law, if any, would be passed on to consumers rather than investors? Bruce Hammond, Chief Operating Officer of MBNA Corporation conceded this point at the joint hearing in which I participated.

There is evidence that excessive tightening of the bankruptcy laws would actually increase credit card defaults and credit card losses, because lenders would be able to make more loans to risky borrowers.

Ausubel, "Credit Card Defaults, Credit Card Profits and Bankruptcy", 71 Am. Bankr. L.J. 250 (1997). This work, by a University of Maryland economist, analyzes credit card lending trends and concludes that credit card interest rates cannot be explained by market forces. In addition, Professor Ausubel concludes that pressures related to risk are important to prevent lenders from making more unwise consumer loans leading to more defaults rather than less.

Non-bankrupt consumers benefit from having a viable, effective and cost-efficient bankruptcy system in case something goes wrong in their lives.

Every American is vulnerable to financial problems related to job loss, illness, death of a bread winner and a myriad of other circumstances beyond their control. Even former Treasury Secretary John Connally was forced by circumstances to file bankruptcy.

The fundamental reality is that the bankruptcy system serves as insurance when unexpected financial problems strike. Although there is no proof of a connection between the bankruptcy law and interest rates, (and some proof to the contrary), even if there were proof, American consumers can and should be willing to pay a small premium for the safety valve inherent in a court system designed to help them during times of financial distress.

WHAT WOULD MAKE THESE BANKRUPTCY BILLS MORE CONSUMER FRIENDLY?

Do not increase opportunities for creditors to pursue litigation against indigent debtors in bankruptcy and avoid new requirements that would raise the costs and burdens of filing.

There is no dispute that debtors that can afford to pay back their creditors should be made to do so. However, the means test provision is only one of 70 provisions that would affect consumer bankruptcy. The net result of the means test and these other provisions is that they would greatly increase the cost of bankruptcy and reduce its effectiveness.

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[3] Culhane and White, "Means Testing for Chapter 7 Debtors: Repayment Capacity Untapped?" (American Bankruptcy Institute, 1998).

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

[5] Medoff and Harless, The Indebted Society, at pp. 12-13 (Little, Brown & Co. 1996).

If the proposed legislation passes, only relatively well-off debtors will be able to afford relief in the bankruptcy system. They can hire expensive lawyers to navigate the new minefields. Most non-wealthy families will be unable to afford the system. Those few that can will be vulnerable to new creditor-initiated litigation that they cannot afford to defend.

Create a balanced bill which includes new consumer protections designed to help consumers avoid over-extension on debt and bankruptcy.

Credit card marketers go to great lengths to encourage people to generate big balances on their cards so that they pay more interest. Most even punish consumers facing legitimate financial problems by charging punitive late fees and by automatically doubling interest rates upon default.

Any fair and balanced bankruptcy bill must include provisions designed to give consumer adequate information about the consequences of taking on on more debt. Some example of important protection are:

- information sufficient for consumers to understand how long and how much it would cost to pay off a credit card loan by making only minimum payments;
- information about the risk of repossession associated with credit card security interests;
- a clear picture of what it means to accept a credit card carrying an artificially low "teaser rate";
- better information for bankruptcy debtors about the costs and risks associated with reaffirming a debt in bankruptcy;
- protections for debtors forced into bankruptcy by high rate mortgage loans that violate federal law;
- protections/incentives for consumers that are responsible and pay their balances in full every month;
- sanction for overly aggressive collection efforts which force people into bankruptcy (e.g. refusal to agree to a reasonable debt management plan, or threatening to take an action which is not legally permissible);
- better education when bankruptcy is filed to teach people how to understand and manage credit; and
- a provision which insures that any profits generated by tightening the bankruptcy laws is passed on to consumers.

Including these provisions in the bill would not just benefit consumers. Honest and reasonable creditors that act responsibly in the market place would also benefit, because more money would be available for consumers to repay their debts.

Thank you for the opportunity to respond on behalf of consumers to this important question.

EDITH H. JONES' RESPONSES

U.S. STATES COURT OF APPEALS,
FIFTH CIRCUIT,
Houston, TX, March 22, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

Re: Joint Hearing of the House Subcommittee on Commercial and Administrative Law and the Senate Subcommittee on Administrative Oversight and the Courts on Bankruptcy Reform, March 11, 1999

DEAR CONGRESSMAN HYDE: Attached you will find my answers to questions submitted in writing as a followup to the March 11 hearing on bankruptcy reform. Thank you for giving me the opportunity to respond to these questions.

Very Truly Yours,

EDITH H. JONES

cc: Honorable George W. Gekas

FOLLOWUP QUESTIONS FROM SENATOR CHUCK GRASSLEY:

1. *You are a Federal Appeals Court judge who hears bankruptcy appeals. Do you think a bright-line rule with respect to means-testing helps judges make clear and consistent decisions?*

Yes. Whenever clear standards are embedded in the law, the law is more easily applied by the court and more easily followed by the citizens. The desirability of uniformity cannot be over-emphasized.

When the 1978 Bankruptcy Code was written, only approximately 300,000 bankruptcies were filed annually. The Code conferred enormous discretion on bankruptcy judges with the thought that they could use that discretion to accomplish justice in each individual case, both to enhance the fresh start and to curb abuse. Virtually open access to bankruptcy relief was provided by the Code.

As Congress is aware, the number of consumer bankruptcy filings has more than quadrupled in the last 20 years. Any thought of tailoring justice to the individual case is now a mirage. Cases are routinely processed en masse in the courts, and most debtors never even see a judge. The participants in the mass bankruptcy system—debtor's lawyers, Chapter 7 and Chapter 13 trustees, U.S. Trustees, and judges—have neither the time, the resources, or the incentives thoroughly to police the system. For creditors, the costs of rooting out and curbing abuse and fraud through a litigation-oriented system are prohibitive. I hasten to add that I am not castigating any of the participants in the bankruptcy system, but I must observe how the sheer volume of filings has undermined the original ideal of dispensing individualized justice.

The only practical, fair way to run a system as large as the current one is by means of objective standards that define when a debtor should be required to repay some debts in exchange for receiving a discharge and fresh start. Congress, as the people" representatives, is best situated to articulate uniform standards.

2. *During your tenure on the Bankruptcy Review Commission, did you propose a means-testing provision?*

In a dissent to the Commission Report, Commissioners Shepard and I proposed five different means-testing provisions, several of whose features resemble H.R. 833.[1] This and other dissents explain that the Commission's process with respect to consumer bankruptcy, flawed from the outset, prevented serious consideration of most meaningful reforms to counter abuse and fraud.[2] Means-testing in particular never had a hearing in the Commission.

Since the Commission completed its tenure, however, the argument for means-testing has become increasingly compelling for two reasons. First, the number of personal bankruptcies continues to increase and remains at an incredibly high level. Second, more empirical studies are confirming the seminal work of Professors Barron and Staten; the studies all demonstrate that tens of thousands of well-off, employed people have filed bankruptcy despite their ability to repay (in total) billions of dollars to creditors. *See, e.g.*, the new Ernst & Young study based on 1997 bankruptcy petitions; See also, Jones and Zywicki, It's Time for Means-Testing, 1999 B.Y.U.L.J.1 (attached to my testimony for this hearing). Such freeloading is an affront to the hardworking, lower-income citizens who bear the cost of bankruptcy losses, and it is fundamentally inconsistent with the means-testing rationale behind nearly all of the other programs in our government's social safety net.

FOLLOWUP QUESTIONS FROM SENATOR TORRICELLI:

A. *You have commended Congress for rejecting findings of the National Bankruptcy Review Commission, of which you were a member. However, 7 out of 9 Commissioners chose not to recommend to Congress that it consider a formal means testing system. Now we have heard that the only recent independent study on this subject, sponsored by the American Bankruptcy Institute, found that even if we did turn the system upside down, only a small portion of chapter 7 debtors could pay even 20% of their debts. In addition, we have a witness here who often represents unsecured creditors and who is telling us that she thinks the means test does not work. In light of these factors, why should we move to a formulaic means testing system?*

The reasons why we should move to a formulaic means-testing system, of the sort proposed by H.R. 833, are fully stated in the testimony I submitted previously for

[1] See Additional Dissent of Commissioners Jones and Shepard from [NBRC] Recommendations for Reform of Consumer Bankruptcy Law.

[2] Recommendation for Reform of Consumer Bankruptcy Laws by Four Dissenting Commissioners; Dissent from the Process of Writing the NBRC Report by Commissioners Gose, Jones and Shepard.

this hearing as well as the testimony of Professor Todd Zywicki for the same hearing. Rather than burden the record further, I refer you to those sets of remarks.

I must, however, respectfully disagree that the "factors" to which you refer counsel against means-testing. First, it is incorrect that "7 out of 9 Commissioners chose not to recommend to Congress" a formal means-testing system. As my previous answer to Senator Grassley notes, the Commission never formally considered and debated means-testing. Had it been given a fair hearing, I don't know what the Commission would have concluded.

Second, I respectfully disagree that the only recent "independent" study on means-testing is that sponsored by the American Bankruptcy Institute. Although I respect ABI, its membership consist of professionals who make their living from the bankruptcy system. If the mere source of a study constitutes bias, then surely ABI is not less immune to the charge than the creditor groups which have sponsored studies of other researchers.

But to challenged ABI or the professors who conducted the ABI study on such a basis is as unfair to them as it is to the creditor groups and the studies conducted by Ernst & Young, The WEFA Group, and Professors Barron & Staten. In our recent article on means-testing, Professor Zywicki and I analyze all of these studies and conclude that they reflect a significant ability on the part of high income-earning Chapter 7 debtors to repay unsecured, non-priority debt. Please see our article, attached to my testimony, at pp. 10–24.

Third, I respectfully disagree with the witness who thinks that the means-test does not work. No matter what the *lawyers* for unsecured creditors say about means-testing, it can be hardly doubted that the creditors themselves favor it. Significant advocates of H.R.833 include child support enforcement agencies, the National Governors' Association, and every major creditor group.

Further, Professor Zywicki's and my article deals at length with objections that have been made to means-testing. In brief, such objections overlook several points. First, means-testing is easily amenable to information procession software. Second, if means-testing imposed more costs on trustees, the costs could be recovered by such devices as increasing filing fees for means-test-eligible debtors. Third, while there may be initial legal uncertainty surrounding some facets of a means test, the same is true whenever any change occurs in the law. The initial court decisions will resolve such uncertainties.

B. *Supporting the concept of needs based bankruptcy is one thing; supporting the* details *of this bill's means testing approach is another. Even if you support a "means based" system in theory, aren't you concerned by the logistical problems that have been identified regarding this means test by the Commercial Law League, trustees, judges, and the National Bankruptcy Conference?*

As you observe, interest groups in the bankruptcy community have opposed means-testing as embodied in H.R. 833. In my experience, however, these same interest groups have opposed any type of means-testing in any form. While saying they are opposed to the details of specific proposals, their opposition is more to the details of specific proposals, their opposition is more philosophically rooted. These groups tend to believe that bankruptcy should operate on an open-door policy, where anyone—no matter how well off—can avail himself of the process without having to justify his need for relief. These groups also tend to deny the power of the growing evidence that shows many well-off income-earning individuals file bankruptcy notwithstanding their ability to repay some debt.

When forced to confront the problem of debtors who are able to repay some of their debts, these interest groups advocate giving the bankruptcy judges discretion to week out undeserving cases. The judges have had this discretion for 20 years, and it has obviously not worked! The number of cases had exploded, while the integrity of the system has declined.

The H.R. 833 proposal is about as fair as can be devised given its modest application, its reliance on established national guidelines for living standards, and an "exceptional circumstances" exclusion. Further logistical simplicity could be achieved, however, by going back to last year's "up-front" test contained in H.R. 3150. That proposal imposed less of a burden on Chapter 7 trustee, who, under H.R. 833, will probably have to litigate more cases under a section 707(b) test. Nevertheless, critics underestimate the clarity that will be achieved from having uniform national standards in this area. I am confident that, just as accountants and CPAs adjust to far mor complex modifications of our federal tax laws, so the bankruptcy community participants can adjust to this modest means test.

C. *As a judge, do you think it is appropriate to make debtors' lawyers personally and financially responsible if their clients are found to have filed under the wrong chapter?*

I believe you are referring to § 101(b) (3) of H.R. 833, which imposes on debtors' lawyers (1) a responsibility similar to that in Fed. R. Civ. Proc. 11 for certifying the debtor's filings at court and (2) a provision for fee-shifting in cases where the means-test is egregiously evaded. I do not see why debtors' lawyers should be immune from the potential liability that any lawyer faces when filing a pleading in federal court: if the lawyer has no reasonable basis for believing in the accuracy of the pleading, he may be subject to sanctions. Such a device is necessary to maintain the integrity of conduct in federal courts and to avoid drowning our meritorious claims with those that have no real foundation. Further, all lawyers have an ethical responsibility to deal fairly with the court and with their opponents. Why should bankruptcy be any different?

The fee-shifting provision is written in language similar to that of numerous federal statutes, which provide for an award of fees if the litigant's position was not "substantially justified." The provision is discretionary, not mandatory. This provision is matched by an equal and opposite provision for fee-shifting if a motion to require conversion under the means-test is itself not "substantially justified."

Scandalously, the entire bankruptcy community acknowledges that debtors' schedules and statements of affairs, which list their income and assets as well as liabilities, are neither accurate nor trustworthy. This is true although the documents are filed under penalty of perjury, and competent counsel should be advising their clients about the risks of filing inaccurate papers. Unfortunately, debtors' lawyers, whose offices often mass-process bankruptcy petitions, see no to be fulfilling their ethical responsibilities. Strong medicine like that in this bill is necessary to enhance the integrity of documents filed in bankruptcy court. No one has proposed any better device.

D. *Even if we make it less "easy" to file for bankruptcy so that the filing rate goes down, it seems to me that we have looked at only one half of the problem because some people are going to default on their obligations whether or not they "discharge" their debts in bankruptcy. Can you comment on this? Do you think that more needs to be done to help prevent people from incurring so much debt in the first place?*

This questions seems to indicate that no matter what changes are made to bankruptcy law, some people will default on their obligations, and maybe their defaults are due to excessive levels of personal debt. I agree that bankruptcy reform addresses one major problem—abuse of the bankruptcy laws. Insofar as law serves a teaching function for society, of course, tightening up the bankruptcy laws sends a message to society at large that it is better to keep contracts than to break them—especially if you are able to repay. I don't think we can quantify this teaching function of the law, however.

Whether "incurring so much debt" is a social problem or not is a question beyond bankruptcy law and within the special capability of Congress. Logically, those who are afraid that people are incurring too much debt ought to be just as concerned about the non-bankrupt who is hard pressed by obligations as they are about the welfare of the bankrupt individual. If Congress thinks interest rates are too high, it can re-impose usury ceilings. If it thinks credit practices are too lax, it can institute additional truth-in-lending or credit controls. Congress should undertake such measures after full public debate, however, rather than indirectly through manipulation of bankruptcy laws. Such a debate would pit those who paternalistically fear consumer credit against those who believe that the wise use of "democratized" consumer credit, home loans and student loans has contributed enormously to increased personal welfare and our economic prosperity.

E. *Using conservative economic theories, some researchers believe that restricting bankruptcy laws will increase defaults and ultimately increase bankruptcy filings. Do you disagree with those conservative economists?*

This is a difficult question to answer for two reasons. First, I am unfamiliar with those "conservative economists" to whom the question refers. Second, the observation that "restricting bankruptcy laws will increase defaults and ultimately increase bankruptcy filings" is flatly inconsistent with the previous question, which assumed that bankruptcy filing rates will go down if access to bankruptcy restricted.

On one level, I guess these contradictory assumptions symbolize that no one knows what will happen to bankruptcy filings if this reform bill is passed. The case for reform does not, however, depend on how it will affect the number of filings. Reform is justified to prevent patent abuses that are now occurring, such as misuse of bankruptcy by ex-husbands trying to avoid their marital obligations. Reform is justified to prevent people from "loading up" on consumer purchases just before filing bankruptcies to discourage them for from incurring new secured debt just before for filing Chapter 13; to prevent them from filing multiple bankruptcies; and to pre-

vent other inarguable abuses. Reform is also justified to incorporate an ability-to-repay test into bankruptcy, at least for those Americans who are above the median family income and who are truly able to repay. If these abuses of the bankruptcy law and courts are rectified, it does not matter to me whether the filing rate goes up or down, because the public can be more confident that the law is being properly used to protect honest but unfortunate debtors.

FOLLOWUP QUESTION FROM SENATOR KOHL:

The National Bankruptcy Review Commission, which you served on, recommended a $100,000 cap on homestead exemptions. I have introduced legislation that would establish such a cap. We have heard from some of the states with unlimited homestead exemptions that a $100,000 cap would unfairly infringe on states' rights. Cap supporters argue that debtors are using federal courts and federal laws to get bankruptcy relief, and it is fair to make them subject to federal limits in order curb egregious abuses, like the recent example of long-time Florida resident Burt Reynolds who wrote off over $8 million in debt through bankruptcy while still holding onto his $2.5 million estate. Do you agree with this recommendation of the NBRC? Please explain your response, including your reaction to arguments from both sides.

In principle, I do not oppose a $100,000 cap on homestead exemptions, particularly if it were indexed to account for inflation.

I agree with cap supporters that debtors have used liberal homestead laws, like that of my home state Texas, to shelter large amounts of wealth from their creditors. It is also true, however, that states have been firmly attached to requiring federal recognition of their exemption laws, including their homestead laws, in the federal bankruptcy courts.

The question is how to prevent abuse of bankruptcy Section 126 of H.R. 833 would discourage a great deal of abuse by lengthening the residency required before a debtor can take advantage of a state's exemptions. Thus, a debtor would have to live in Texas for two years (rather than the current three months) in order to avail himself of Texas homestead protection. A more general reform would limit transfers of real or personal property from non-exempt to exempt status shortly before filing bankruptcy. In short, while I personally do no object to $100,000 cap, other kinds of limitations can reach the same goal.

JUDITH GREENSTONE MILLER'S RESPONSES

COMMERCIAL LAW LEAGUE
OF AMERICA,
Chicago, IL, March 22, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CHAIRMAN HYDE: I understand that since the Joint Hearing of the House Subcommittee on Commercial and Administrative Law and the Senate Subcommittee on Administrative Oversight and the Courts on Bankruptcy Reform held on March 11, 1999 (the "Joint Hearing"), additional written questions have been submitted for inclusion in the record. The Commercial Law League of American (the "League"), its Bankruptcy and Insolvency Section ("B&I") and its Legislative Committee appreciate the opportunity to have appeared and testified at the Joint Hearing about the Bankruptcy Reform Act of 1999, H.R. 833 (the "Bill").

The League, founded in 1895, is the nation's oldest organization of attorneys and other experts in credit and finance actively engaged in the fields of commercial law, bankruptcy and reorganization. Its membership exceeds 4,600 individuals. The League 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 involved.

The B&I is made up of approximately 1,600 bankruptcy attorneys and bankruptcy judges from virtually every state in the United States. Its members include practioners with both small and large practices, who represent divergent interests in bankruptcy cases. The League has testified on numerous occasions before Congress as experts in the bankruptcy and reorganization fields.

The League supports changes to the Bankruptcy Code (the "Code") to limit abuses by debtors and creditors. Any proposed change will have consequences on the system. It is the goals of the League to be a resource for Congress and to help Congress carefully consider the practical implications of each change in order to maintain and preserve the delicate balance between debtors' rights and creditors' remedies and to

foster and effectuate fair treatment for all parties involved in the process. With that in mind, the League is pleased to respond to the two written followup questions submitted by Senator Torricelli.

Question 1:

Some people have argued that individuals and groups voicing opposition or concerns about the bill are simply trying to block reform and believe that b buses should not be addressed. If this is the case, why is a creditor oriented group like the Commercial Law League of American voicing objections about the bill?

Response:

There are those who are opposed to any change in the Code. On the other hand, many pursue specific agendas. Some feel that there should be no limits on relief for a debtor or remedies by a creditor. As indicated about, the League views itself as a resource to Congress to offer a practical, balanced analysis to proposed legislation. The League believes that it should do all it can to support Congressional efforts to maintain a Code which provides fair treatment to all participants in the system. While this position is sometimes not politically popular because it may not fall on the side of an issue favored by a proponent, nevertheless, it is a consistent position taken by the League. The fact that members of the League represent all types of creditors, as well as debtors, frees the organization from the need to advocate the interests of any particular creditor group or to pursue any specific agenda.

The League has consistently articulated in its written position papers and statements and its testimony before Congress the need for reform to address and remedy abuses by debtors and creditors in order to improve the bankruptcy system. Although the Bill proposes many favorable changes to the Code that the League has endorsed, the Bill also proposes several modifications, which, if adopted, will negatively impact creditors, as well as other participants involved in the bankruptcy process. For example, the anti-strip down provisions of the Bill that seek to amend Section 506(a) of the Code, *see e.g.*, Sections 124 and 125, required a debtor to repay a secured creditor based on the full amount of the debt even though the value of the property securing the debt may be significantly less than the amount of the outstanding indebtedness. Under applicable state law, if the secured creditors foreclosed on the loan in order to recover their collateral, the creditors would not receive in excess of the fair market value attributable to the property, and then be left with an unsecured deficiency claim against the debtor. Why should the procedure be any different under the Code? Why does Congress believe it necessary to alter Section 506(a) of the Code, particularly when the result will be that less funds will be available to pay unsecured creditors of the estate and the ability of a debtor to formulate and successfully emerge from a Chapter 13 repayment plan will be significantly compromised?

Another provision of the Bill, Section 205, seeks to extend the time for assumption or rejection of unexpired executory contracts of nonresidential real property from 60 days to 180 days. The only way that this time period may be extended is upon consent of the lessor. The League opposed this provision because it tips the delicate balance contained in the Code by placing landlords of nonresidential real property in the position of forcing assumption or rejection within the earlier of 180 days after the entry of the order for relief or the date of entry of the order confirming a plan. As long as landlords are receiving rental payments consistent with Section 365(d)(3), there is no reason to create an arbitrary, inflexible and unrealistic deadline, which will inure to the detriment of the debtor and its unsecured creditors. The debtor is likely to prematurely assume a lease in order to facilitate a reorganization, and thereby create a large administrative expense for the estate if subsequently it is unable to successfully reorganize. On the other hand, this proposed modification to Section 365 of the Code may force a debtor to prematurely reject a lease necessary and essential to facilitate a reorganization to negate the potential prospective administrative hit from failing to confirm a plan. In addition, the only way that the time period may be extended is upon motion of the lessor; the court would no longer have any discretion to determine whether justification existed to extend the time period or whether an extension was in the best interest of creditors and the estate. This provision gives too much bargaining power to the lessor, is likely to result in the extraction of additional benefits or concessions by the lessors, and impacts the debtor's ability to successfully reorganize, particularly in cases involving multiple shopping center locations. For example, take a debtor with multiple retail locations in shopping centers, who files bankruptcy in March. Under the proposal, the debtor will be forced to make a decision to assume or reject prior to the Christmas season, when sales at that time are so crucial in assessing the likelihood of its reorganization and new business plan.

The League believed that this section of the Code, as currently drafted, appears to be working well, and is not in need of revision. If, however, Congress nevertheless believed that landlords are not adequately protected by the current safeguards contained in the Code (e.g., requirement that debtors timely pay postpetition rental charges, administrative priority treatment for nonpayment of postpetition rental charges, 60-day period to assume or reject that can be extended upon showing of "cause"), the League suggested that Congress may wish to consider bolstering the current Code provisions to provide a better remedy for lessors when debtors fail to perform their obligations under lease postpetition. However, as long as lessors are receiving what they are entitled to under a lease, they are receiving the benefit of their bargain and should not be able to tip the delicate balance by suggesting that Congress establish a rigid and inflexible period by which assumption or rejection takes place, particularly when that decision ultimately affects the potential distribution made to unsecured debtors under a plan.

The two examples cited above clearly evidence that the League is not attempting to block reform, but rather analyze the impact from implementation of such changes. It is important as part of the legislative process to focus on the result of such changes—in both of these instances, unsecured creditors and the debtor will be adversely impacted at the expense of secured creditors and commercial retail lessors. The League has always opposed special interest legislation that has no special policy justification—both of these examples represent special interest legislating that will negatively impact the delicate balance between debtors' right and creditors' remedies inherent within the Code. Remedying one perceived abuse does not improve the bankruptcy system if the result of such curative actions is merely to create another potential abuse.

Question 2:

You seem to have some serious concerns about the means test in this bill and its ability to identify debtors who can pay back their unsecured debts. As a representative of many unsecured creditors, your opinion on this is obviously significant. Are you saying that unsecured creditors are unlikely to benefit from this means test? If so, how should we fix this problem?

Response 2:

The League has expressed concerns about various provisions of the Bill and made suggestions on many changes that it feels would improve the Bill and would remedy and limit abuses by debtors and creditors. The means test as proposed has numerous problems and is not likely to improve the recovery to unsecured creditors. It is also likely to be the subject of creative avoidance efforts by counsel for debtors. Because individuals with secured debt are allowed deductions for such obligations prior to calculating available disposable net income, a debtor with too much income could trade in an old car for a new one, or take a second loan on a house, deduct the payments from the means formula, and thereby become eligible for Chapter 7 relief. If they do not meet the means test, and thus forced into Chapter 13, the result may very well be zero percent or small percentage Chapter 13 repayment plans. The means test also operates to the exclusion of the trustee's significant avoidance powers. The schedules may reveal a significant avoidance action (e.g., preferences or fraudulent conveyances), which if recovered could result in a distribution to unsecured creditors in excess of what they would receive upon application of the means test. However, under the means test, as proposed, if a debtor does not qualify for Chapter 7 treatment and the debtor does not elect to convert the case, the trustee does not have the ability to seek recovery through the avoidance action, a remedy that would clearly benefit unsecured creditors over dismissal of the proceeding.

The League believes that debtors who have the ability to repay their debts should be compelled to undertake such action. The League, however, believes and has suggested that the best way to achieve that goal is by amending Section 707(b) to empower the Court on the motion of any party in interest to consider a debtor's means as a nonexclusive factor in dismissal or conversion—such a change is more likely to benefit the creditors than the mandatory tested currently set forth in the Bill. The Court is in the position to identify abuse and fashion relief appropriate to the circumstances. Under the current Doe, the courts do not have the authority to affirmatively look for abuse or fashion an appropriate remedy except in the most egregious circumstances. Adoption of a "totality of circumstances" test, in conjunction with a discretionary means test, would accomplish the goal for which Congress has proposed the means test, provide a guide for defining abuse by the courts, and represent a major change and a vehicle by which abuse could be addressed and remedied.

The League would be pleased to comment on any additional concerns or queries regarding the pending Bill or other matters of concern to your office.

Very truly yours,

JUDITH GREENSTONE MILLER,
Co-Chair, Legislative Committee,
ON BEHALF OF THE COMMERCIAL LAW LEAGUE OF AMERICA AND ITS BANKRUPTCY & INSOLVENCY SECTION

cc: Hon. George W. Gekas (Hand Delivered)
Hon.Robert J. Torricelli (Hand Delivered)
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PROFESSOR TODD ZYWICKI'S RESPONSES

RESPONSES TO FOLLOWUP QUESTIONS FROM SENATOR CHUCK GRASSLEY

Question 1. You mentioned that means-testing would affect a maximum of all bankruptcy filers, do you know what percentage of filers are reported to be repeat users of their "fresh start", and can you comment on what this number suggests about the current remedies in the consumer bankruptcy system?

The absolute number of repeat bankruptcy filers is difficult to ascertain with certainty. One study in the early 1980s found a repeat filing rate of about eight percent. Professor Lynn LoPucki has observed, "The rate is probably higher today." But these figures almost certainly understate the overall number of "functional repeat filings," the most common of which is the practice of conveying a "fractional" interest in one's house to a relative or other cohort, who then files bankruptcy so as to bring the automatic stay back into effect. In some cases, debtors have conveyed as little as a 1/32 interest to a relative or friend who then files bankruptcy so as to prevent foreclosure. There are even some businesses that have been established to conduct this activity.

A number of reforms may be appropriate to prevent abusive repeat filings by bankruptcy debtors. Perhaps the most important reform would be the development of a national bankruptcy filing registry to deep track of filers and to prevent multiple and sometimes even contemporaneous filings. Because most repeat filings are animated by an attempt to delay and thwart house foreclosures, certain reforms designed to create in rem rights in property (as suggested by the National Bankruptcy Review Commission) and to expedite relief from the automatic stay for repeat filers are also appropriate. Stricter limitations on access to bankruptcy relief, such as a flat limit on the number of times a debtor could file bankruptcy in a given period, would also be appropriate. Finally, to prohibit the "fractional interest" problem, the automatic stay should be inapplicable for anyone who had filed within 180 days, or who are spouses, co-owners, or co-lessees of a person who filed in the previous 180 days.

Question 2. How will means-testing improve the consistency and objectivity in the application of the bankruptcy code?

One of the most important justifications for means-testing would be to increase the consistency, objectivity, and uniformity of the Bankruptcy Code. Article I, § 8 of the United States Constitutions gives Congress the power to establish "*uniform* Laws on the subject of Bankruptcies throughout the United States" (emphasis added). Current law regulating eligibility for Chapter 7 of high-income debtors who can repay substantial portion of their debts is anything but uniform. Under current law, judges are to police abuse through the "substantial abuse" provision of § 707(b). The attempt to develop coherent, fair, and rational standards under § 707(b) has proven itself to be a failure. This chaos has resulted in both real and perceived unfairness in the treatment of debtors from district to district and courtroom to courtroom. The confusion spawned by § 707(b) is summarized in *In re Attanasio*, 218 B.R. 180 (Bankr. N.D. Ala. 1998). *Attanasio* surveys hundreds of cases drawn from bankruptcy, district, and circuit courts throughout the country. As the discussion reveals, there is very little agreement in the legal definition of what constitutes "substantial abuse" and even less agreement on how the facts should be weighed in determining whether substantial abuse exists. Finally, there is a great degree of nonuniformity and unpredictability in predicting when a substantial abuse challenged will be brought under § 707(b). This uncertainty and nonuniformity undermines public support for the bankruptcy system and makes it difficult to prevent abuse.

Means-testing will streamline the system and limit the issues in a given case to narrow and discrete inquiries. By providing a rule of decision tying the applicability of means-testing to objective standards, it will eliminate the uncertainty and regional variations that plague the current system. It will insure that all high-income debtors are treated alike, thereby increasing uniformity and public confidence in the bankruptcy system.

RESPONSES TO FOLLOWUP QUESTIONS FROM SENATOR TORRICELLI

Question 1. The means test in this bill relies heavily on the IRS collection allowances. We have heard lots of concerns about these allowances, even from those who take no position on the bill generally. One problem is the "other necessary expense" category. Since it clearly was not designed for this purpose, the items that fall into the category are totally discretionary with the IRS and are approved on a case by case basis (see IRS regulations 5323.434). Thus, we have no guarantee that these expenses may be deducted from the means testing formula. This is not simply a minor inconvenience; families in bankruptcy will need to use this category for such things as health care, child care, disability insurance, union dues, and court-ordered payments (such as support), because the IRS collection allowances do not cover these critical expenses anywhere else. How is this supposed to work?

Section 102 of H.R. 833 approves such expenditures by the debtor so long as they are actual necessary expenses. If they are actual necessary expenses, there would be no need for the debtor to prove that they are "other necessary expense" for purposes of the applicable IRS regulations. Unlike the IRS regulations, the debtor would be entitled to subtract these actual expenses without a case-by-case justification. All that is required is that they be actual expense.

Question 2. The means test in this bill requires a trustee to do a complete ability to pay analysis under the means test in every single chapter 7 consumer case at the very beginning of the case, 10 days before the 341 meeting, before the trustee has even met any of the debtors. People who actually work in the bankruptcy system say that this simply is not feasible. In addition, the trustees would not even be compensated for this extraordinary expenditure of time. Don't you think that there are serious feasibility requirements with the means test?

These concerns are not well-founded. The crucial information would be available directly from the debtor's bankruptcy schedules and forms. For instance, the trustee is required to bring a conversion motion only if the debtor's income exceeds the national median, in addition to meeting the other ability-to-pay criteria. Thus, in the approximately 80% of cases where the debtor's income is less than the median national income, means-testing will impose no additional duties over present law. Moreover, the Act also specifically provides that the applicable bankruptcy forms should be revised to conform to the means-testing requirements, thereby making it easier for the trustee to determine the applicability of means-testing. This is merely a change in the format of the income and expense forms the debtor already is required to fill-out under current law. Thus, means-testing should add little, if any, administrative burdens to the trustee's duties. Thus, it is doubtful that means-testing would be any less feasible than current law.

Question 3. As a law professor who has studied the bankruptcy system, do you believe that it is appropriate to give lawyers a financial disincentive to file chapter 7s for their clients if they believe that doing so is in the best interest of their clients? Are you concerned that creating such financial disincentives for lawyers to act in their clients' best interests will run afoul of other ethical requirements?

It is not fully clear to me what "financial disincentive to file chapter 7s" is referenced in this question. I will assume that the question refers to the provisions what would require the debtor's counsel to reimburse the trustee for all reasonable costs and attorney's fees if the debtor's filing was not "substantially justified" and provisions for enforcing Rule 9011. If that is the case, it seems strange to refer to these ethical requirements as a "financial disincentive." Clearly these rules provide a financial disincentive for a debtor's attorney to file frivolous chapter 7 cases and to file cases where the debtor's lawyer fails to perform even a modicum of investigation into the debtor's financial affairs. Rule 9011 also gives a debtor's lawyer a financial disincentive to engage in fraudulent or other inappropriate activity, even if it is the client's best interests. The requirements of the proposed legislation require the debtor's lawyer to balance his ethical obligations to the debtor with his ethical obligations to the court and his fiduciary obligations to creditors. All lawyers balance these competing ethical obligations every day, and it is not clear why bankruptcy lawyers should be relieved of this obligation, or why it is useful to refer to ethical obligations as "financial disincentives to file chapter 7s" as opposed to "finan-

cial incentives to ensure that chapter 7 filings are made in good-faith and after reasonable investigation by the debtor's counsel."

RESPONSES TO FOLLOWUP QUESTIONS FROM SENATOR RUSS FEINGOLD

Question 1. You testified that "studies repeatedly conclude that those affected by means-testing could pay approximately 60%–70% of their unsecured debts if they filed under Chapter 13, which amounts to a total of over $4 billion." Do you have a source for this $4 billion number, other than the report of the WEFA Group study that did not provide sufficient information for the General Accounting Office to be able to assess the reliability of the data, the reasonableness of the report's assumptions, and the accuracy of the report's estimates of creditor losses and the bankruptcy system's costs in 1997? See *"The Financial Costs of Personal Bankruptcy" Letter from Associate Director Richard Stana to the Honorable Martin T. Meehan, GAO/GGD–98–116R.*

$4 billion is an approximation that comes from a analysis of several studies that report similar conclusions. In addition to the WEFA study, the Ernst & Young study of nationwide sample of petitions drawn from 1997 filings concluded that those affected by means-testing would have had the ability to repay 64% of their unsecured nonpriority debts, which represented over $4 billion. See Tom Neubig & Fritz Scheuren, Ernst & Young, Chapter 7 Bankruptcy Petitioners' Ability to Repay: The National Perspective, 1997 (March 1998). That report further concludes that "the WEFA estimates may have understated the amount of debt in the system, and consequently, may have underestimated the financial costs of the personal bankruptcy system." While other studies do not directly state the amount of money that would be captured by means-testing, it is a matter of simple mathematics to calculate the amount recoverable as a result of means-testing. These earlier conclusions were based on the provisions of last session's House bill, H.R. 3150. I am not aware of any studies of sufficient scope and credibility that would cast doubt on the conclusions drawn from a meta-analysis of these several studies.

Subsequent to my testimony, Ernst & Young released a new study that applies the provisions of the current bill H.R. 833 and revises its conclusions to conclude that those affected by the means-testing provisions of H.R. 833 would be able to repay $3 billion of their unsecured nonpriority debts over five years.

Upon reviewing these various studies, the Government Accounting Office concluded that the studies of the Credit Research Center and Ernst & Young "[b]oth . . . represent a useful first step in addressing a major public policy issue—whether some proportion of those debtors who file for personal bankruptcy under chapter 7 of the bankruptcy code have sufficient income, after expenses, to pay a 'substantial' portion of their outstanding debts." The GAO also notes that actual number of chapter 7 debtors who could repay at least a portion of their nonhousing debt "could be more or less than the estimates of these two studies. Similarly, the amount of debt these debtors could potentially repay could also be *more* or less than the reports estimated" (emphasis added). Thus, according to the GAO, the studies may *underestimate* the total number of filers who could repay a substantial amount of their debt. Given that the authors of those reports deliberately made conservative estimates of repayment ability, it is more likely that they understate rather than overstate their results. Not only that, but GAO's reasons for suggesting that the findings of repayments ability are overstated is implausible on its face. For further discussion of the problems with GAO's assumptions, see Edith H. Jones and Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. L. Rev. at n.67.

Question 2. You testified that "95% of Chapter 7 bankruptcy filings make no distribution at all to unsecured creditors, and those that do rarely pay out more than a trivial amount" and went onto suggest that creditors receive a much larger payout in chapter 13 cases. However, VISA U.S.A. studies the Creighton University reaffirmation study indicate that a substantial portion of chapter 7 debtors reaffirm their debts and thus continue to pay one or more of their unsecured debts, notwithstanding the fact that they have no nonexempt property to be liquidated in the course of the bankruptcy case. The chapter 13 plan completion rate is low, and many times plans are terminated before payments to unsecured creditors are commenced. Moreover, some plans are 0% plans and never intend to pay unsecured creditors at all.

Question (A) Do these factors affect your comparison of the benefits of the two chapters?

As an initi matter, it is not clear to me why reaffirmed debt should be considered a "distribution" to unsecured creditors. It would seem more sensible to think of amounts paid due reaffirmations as exactly that, rather than as distribution in the

chapter 7 case, which would relate to payments made on claims through the chapter 7 case.

Otherwise, the overall chapter 13 failure rate and the existence of 0% plans does not alter the conclusion that in general chapter 13 pays larger distributions to creditors than chapter 7 cases. It's a matter of common sense. In chapter 7, neither high-income nor low-income debtors make significant distributions to creditors. In chapter 13, by contrast, high-income debtors will make distributions even if low-income debtors do not. *Ceteris paribus*, larger amounts will be distributed in chapter 13 because the distribution as a result of high-income filers being forced to pay will be larger than the amounts these debtors would distribute in chapter 7. It follows that by forcing high-income debtors to file chapter 13, means-testing will target exactly the class of debtors from which these larger payouts are available.

The overall chapter 13 failure rate is irrelevant to a comparison of the benefits of the two chapters as they relate to those covered by means-testing, namely high-income debtors who have the ability to repay a substantial portion of their debts without significant economic or other hardship. Debtors currently file chapter 13 for a variety of reasons, most of which have nothing to do with their ability to repay in chapter 13. For instance, debtors often use chapter 13 to take advantage of the automatic stay and to repay mortgage arrearages. Once they do, the case is dismissed and the case is listed as a "failure," even though there was not anticipation from the beginning that the plan would be completed. Other cases involve low-income or debtors with irregular income-earning patterns who mistakenly or ill-advisedly file chapter 13. It is unclear how many chapter 13 filers fit the profile of those subject to means-testing; high-income debtors with regular employment who are forced in chapter 13 specifically *because* of their ability to pay a substantial portion of their debts, and not for the various other reasons that often lead people to file chapter 13.

Question (B) Do you have any data to make a more complete comparison between the payouts from chapter 7 and chapter 13 debtors?

The basic conclusion that distributions to creditors in chapter 7 are small is well-established. See Michelle J. White, *Personal Bankruptcy Under the 1978 Bankruptcy Code: An Economic Analysis*, 63 Ind. L. J. 1 (1987); Michael J. Herbert & Dominic E. Pacitti, *Down and Out in Richmond, Virginia: The Distribution of Assets in Chapter 7 Bankruptcy Proceedings Closed in 1984–87*, 22 U. Rich. L. Rev. 303 (1988); Note, *A Reformed Economic Model of Consumer Bankruptcy*, 109 Harv. L. Rev. 1338 (1996) (discussing several studies of distributions made in chapter 7 cases). Several studies in the past year or so have identified the substantial recoveries available as a result of forcing high-income debtors to file under chapter 13 rather than chapter 7.

Question 3. You testified that the reach of means-testing is small in terms of the number of filers impacted but that its impact would be large in terms of the amount of money collected. In light of this view, do you believe that it is necessary or efficient to review all cases for ability to pay under the means test, even cases of debtors with income below the poverty level, as section 102 of H.R. 833 currently requires?

This question appear to be based on confusion regarding the provision of section 102 of H.R. 833. Section 102(b)(2) of H.R. 833 requires the trustee to bring a motion to dismiss or convert only if the debtor's income is above the national median income and the other means-testing criteria are met. If the debtor's income is below the national median income, then means-testing is irrelevant and the trustee would not be required to review for ability to pay under the means test.

Question 4. Your testimony suggests that a means test should identify those debtors with high incomes who could repay creditors, such as the doctor in the case of In re Kornfield*, 164 F.3d 778 (2d Cir. 1999). Your testimony also suggests that although the current system has been successful in denying relief to debtors such as Dr. Kornfield, current law permits those debtors to continue to contest the denial of relief by filing and litigating appeals. You probably would get little or no argument from debtor advocates that individuals like Dr. Kornfield may not be deserving of chapter 7 relief. However, some observers have questioned whether the means test in H.R. 833 will actually be able to catch someone like Dr. Kornfield; after all, an individual with his sophistication and legal resources will be able to inflate and shape his debts and expenses to escape the means test.*

I have not suggested that anyone should be "denied [bankruptcy] relief." I have argued that bankruptcy relief should be *conditioned* in *some* cases on the repayment of one's debts to the best of one's ability, and that one such case is that of a high-income debtor who can repay a substantial portion of his debts with no significant financial or other hardship. H.R. 833 would not deny relief to any debtor, although

it would limit access to chapter 7 by some debtors, and would force them to seek relief under chapter 13 instead of chapter 7.

The current system has not been successful in systematically preventing abuse by debtors such as Dr. Kornfield. In Dr. Kornfield's *particular case*, the system worked to dismiss his case for substantial abuse, but only after great delay, expense, and litigation. This should not be read as an endorsement of the current *system* of policing abuse under § 707(b), a system that is racked with nonuniformity, uncertainty, and real and perceived unfairness.

Question (A). Do you agree that the means test in H.R. 833 provides leeway for wealthy and savvy individuals, the Dr. Kornfields of the world, to escape the means test?

Clearly, some wealthy and savvy individuals will attempt to escape the means-test, just as they do under current law. Means-testing is not a panacea that will prevent all bankruptcy abuse by high-income debtors. But by replacing the wide-ranging discretionary standard of current § 707(b) with a more objective rule of decision, means-testing will certainly reduce the leeway for wealthy and savvy individuals to abuse the bankruptcy system. Thus, means-testing should not be expected to completely eliminate bankruptcy abuse, but it should significantly decrease it.

Moreover, even if a strategic debtor is able to evade the means-test, the benefit would be small; i.e., he would just get to file under chapter 7 rather than 13. Thus, "benefit" would be to put him right back where he is under current law, in chapter 7. Means-testing might be rendered irrelevant by bankruptcy planning, but it would not make matters worse. This question apparently does not take account of H.R. 833, section 102(3)(B) which supplements the means-test with discretionary power to find abuse when the "totality of circumstances" requires. A strategic attempt to shape assets and liabilities in a manner designed to evade the means-test would plainly constitute abuse under this "totality of circumstances" test and the traditional § 707(b) standards. This question also ignores the fact that if the debtor did succeed in getting himself into chapter 7 under such circumstances, he would still have to contend with the traditional nondischargeability objections associated with "loading-up" on debt, such as fraud and certain expenditures on luxury goods. Similarly, if he increased his secured debt in an attempt to evade discharge, he would be bound to the higher secured debt in chapter 7, so the strategy would be largely self-defeating.

Question (B). How would H.R. 833 prevent Dr. Kornfield from taking several appeals as he did under current law? After all, with his legal resources, he could contest the "other necessary expense" category of the IRS collection allowances, which are determined on a case by case basis, and he could contest any determination of whether he had "extraordinary expenses."

H.R. 833 would not prevent Dr. Kornfield from taking several appeals. But it would significantly reduce the incentive for Dr. Kornfield to take appeals, as the legal rule would be far more well-defined than the murky discretionary standard of the current law. Thus, the results of the appeals process would be much more predictable and uniform, thereby eliminating much of the incentive for appeal. H.R. 833 would also reduce the costs associated with reviewing cases on appeal. As the question itself suggests, the issues raised by means-testing would be much more narrowly defined than under current law, and thus the factual inquiry would also be much more narrowly tailored and predictable than under current law. Unless the debtor could fit his desired expenses within one of the enumerated categories, he will be unable to prevail. Again, this is an improvement over the rule-less unlimited discretion of the current regime where almost anything goes in an evidentiary hearing. Finally, the question suggests that the IRS approach of determining and reviewing "other necessary expenses" on a case-by-case basis would also be the practice in bankruptcy. This does not appear to be the case with H.R. 833, as H.R. 833 only requires that the expenses be actual necessary expenses, it does not require them to be proven as "other necessary expense" as the IRS would require.

Question 5. You testified that the 1978 Code significantly reduced the economic costs and increased the economic benefits of filing bankruptcy. However, the Code was tightened with amendments proposed by the credit industry in 1984, only to be followed by a sharp increase in filings notwithstanding decreased debt relief. How do you explain this trend?

Multiple scientifically-controlled studies have concluded that the 1978 Code reduced the economic costs and increased the economic benefits of filing bankruptcy, and that the result was an increase in bankruptcy filing rates. I am not aware of any scientifically-controlled studies that have concluded that the 1984 amendments led to increased bankruptcy filing rates. Correlation is not causation; a "trend" by

itself proves nothing at all. It is impossible to draw any conclusion about the effects of the 1984 amendments unless we can establish with reasonable certainty what the filing rate would have been *absent* the 1984 amendments. For instance, filing rates may have increased absent the 1984 amendments for completely unrelated reasons, and the 1984 amendments may have caused this rate of increase to be lower that it would have been absent the 1984 amendments. I am aware of no credible study that has attempted to isolate the effects of the 1984 amendments on bankruptcy filing rates.

Question 6. You testified that economist Michelle White estimates that 15%–20% of American households would financially benefit from filing bankruptcy, especially if they engaged in some planning prior to filing. Since a far smaller percentage of American households file for chapter 7 bankruptcy, doesn't this mean that bankruptcy still carries stigma sufficient to deter the vast majority of families who would benefit from filing?

Yes, absolutely. And well it should, as trust, promise-keeping, and reciprocity provide the foundations of a free economy and healthy civil society. Thus, a desire to keep promises and reciprocate are embedded in our consciousness and moral principles. We feel shame when we break promises and it is appropriate that there is a stigma associated with such an act, as it is a moral; as well as a legal and economic act. And it is almost certainly the case that the residual effect of these principles explains why so few people file bankruptcy even when it is to their financial benefit.

But shame and stigma operate at the *margin* to constrain individuals, they are not absolute concepts. If the economic benefits of filing rise high enough, some people will consider filing bankruptcy who might not have done so previously. Similarly, if the social disapproval associated with bankruptcy falls, some people will consider filing who would not have filed when social approval was greater. Thus, it should not be surprising that a recent study concludes that the constraining effect of filing bankruptcy traditionally has been largest for the very high-income filers who can capture the greatest economic benefit from filing bankruptcy.

Given this, it is not clear why the "vast majority" is the appropriate benchmark for determining the residual effect of stigma on restraining bankruptcy filings. Given the corrosive effect of opportunistic bankruptcy filings and the opportunistic promise-breaking that such filings represent on the economy and on civil society generally, it is not clear why we would tolerate more than the absolute minimum of such opportunistic behavior in society and in the economy.

Question 7. Your testimony indicates that you believe that individual who borrow money or purchases an item should be required to repay it. Drawing the analogy between bankruptcy and shoplifting, you state that "you shouldn't take it if you aren't going to pay for it."

This paragraph reflects a fundamental confusion about my testimony. My analogy is between *unnecessary* bankruptcy losses and shoplifting. I will repeat the relevant passage from my Statement of March 11, 1998 (page 5): "Who are the beneficiaries of means-testing? We all are. To see why, consider that although few of us actually own retail shopping stores, all of us oppose shoplifting and believe that it should be forbidden. The reason why we support laws against shoplifting are analogous to the justification for means-testing." The analogy is clearly between shoplifting and means-testing, not shoplifting and bankruptcy generally.

Question (A). If this is the case, do you think that Congress is wrong to provide a discharge in bankruptcy at all?

That is not the case. I am not opposed to a discharge. I am in favor of placing a *condition* of repayment to the best of one's ability for high-income debtors who can repay a substantial portion of their debts with no significant financial or other hardship.

Question (B). Should society recognize that changed economic circumstances caused, for example, by illness, disability, divorce, or loss of employment might make it impossible for consumers to satisfy debts they had every intention of paying when they incurred them?

Yes.

Question (C). Are you concerned that the lack of a bankruptcy safety valve will hamper entrepreneurs, who currently comprise one in five consumer bankruptcy filings, from engaging in the appropriate level of risk-taking activity?

I am unfamiliar with the claim that one in five consumer bankruptcy filing are failed entrepreneurs, and am very skeptical about that number. Clearly self-charac-

terizations in interviews be self-proclaimed entrepreneurs would not provide a suitable basis for the conclusion. More fundamentally, I am confused as to the premise of the question. Eliminating a bankruptcy safety valve would undoubtedly reduce risk-taking, just as eliminating limited liability for corporations would reduce risk-taking. I am not aware of any efforts to eliminate bankruptcy generally, nor am I aware of any efforts to eliminate the discharge or the fresh start. Thus, I am somewhat confused as to the premise and purpose of the question.

Question 8: You state in your testimony that "a borrower's willingness to take on debt clearly will be related to the ease with which he can later discharge those debt obligations if he chooses to do so." This statement assumes that consumers incur obligations with the understanding of their true costs. Some economists believe that many consumers systematically underestimate the extent of their borrowing and the cost of repayment and therefore make sub-optimal borrowing decisions. If this is the case, changing the bankruptcy law will not affect the borrowing decisions of many consumers. To enable consumers to make more rational borrowing decisions that will be less likely to lead them into financial distress, particularly if the bankruptcy laws are going to be tightened and consumer credit remains freely flowing, do you believe that open end credit should be accompanied by additional disclosures that reveal to the potential borrower the actual costs of credit?

The assumption of this question appears to be the complete opposite of that in question 7. In question 7 it was assumed that if bankruptcy relief was restricted, then individuals would take fewer risks for fear of incurring nondischargeable losses. This question appears to assume that a borrower's willingness to incur debt and risk losses will be unaffected by its dischargeability in bankruptcy. Despite these changes in the factual predicate of the question, my answer remains the same; the willingness of individuals to incur debt will to some extent be a function of their ability to discharge that debt in bankruptcy.

The belief among "some economists" that individuals systematically underestimate the extent of their borrowing and repayment obligations has been proven incorrect in recent years. The premise for this view seems to be rooted in the dubious and outdated research of economist Lawrence Ausbel's in his 1991 article in the *American Economic Review*. Virtually every element of Ausbel's research has been shown to be flawed, dated, or both. The basic methodology used to collect the data that underlies the so-called "underestimation hypothesis" has been criticized. See Thomas F. Cargill & Jeanne Wendel, *Bank Credit Cards: Consumer Irrationality versus Market Forces*, 30 J. Consumer Aff. 373, 375–77 (1996). For instance, Ausubel dramatically overstates the number of consumers who revolve balances from month-to-month. The Survey of Consumer Finances indicates that approximately 68% of households report that they nearly always pay their credit card balances in full. Even where Ausubel's methodology for collecting data passes muster, the conclusion of chronic underestimation by consumers is simply not a plausible conclusion to draw from the data he collects. *See* Dagobert L. Brito & Peter R. Hartley, *Consumer Rationality and Credit Cards*, 103 J. Pol. Econ. 400 (1995). For instance, Ausubel makes no attempt to distinguish so-called "irrational" credit revolving from "rational" use of credit cards to finance short-term swings in consumption or as an attractive form of short-term borrowing (compared to alternative sources of low-transaction cost short-term borrowing). I am not aware of any effort on Ausubel's part to respond to the criticisms of his research that have been launched by Cargill & Wendel or Brito & Hartley. I have personally contacted him to see if he intends to respond, but I have received no response. In short, at the current time, there is little reason to believe that the underestimation hypothesis has any validity whatsoever.

Moreover, the proposition begs common sense. Short-term consumer credit seems like an unusual scenario for the underestimation hypothesis to arise, when compared to more plausible situations. For instance, student loans and mortgages would seem to raise the underestimation hypothesis more powerfully, as both forms of credit are for much longer repayment terms, sometimes as much as 15–30 years. Similarly, yearly tax obligations are also much larger than consumer debt burdens, yet we force individuals to anticipate their tax obligations and pay them. In all of these situations the complexity and size of the obligations, combined with the length of time for repayment suggests that the underestimation hypothesis would seem to be far more troublesome than on monthly consumer credit payments.

Given that the underestimation hypothesis has little theoretical or empirical support, it is not clear what difference additional disclosures would make. Consumers appear to be well-aware of how much debt they are incurring and know exactly where they are spending it. If individuals are capable of anticipating and paying their student loans, mortgages and taxes they certainly are able to anticipate their monthly credit card bill. Credible empirical studies confirm this.

Question 9. You testified that consumer credit is not to blame for the bankruptcy filing rate. The credit industry witnesses agreed with you, noting that credit card debt is only 3.7 percent of consumer credit overall and bank card debt (presumably a subset of all card debt) is only 16% of all debt (including secured debt) in bankruptcy. However, don't these numbers alone indicate that the individuals and families who ultimately resort to bankruptcy have inordinately high credit card debts as compared to the population as a whole?

I am not sure what the term "inordinately high" means. I have a Master's degree in economics and have studies statistics and econometrics, and I am familiar with the term "statistically significant" which is a term that suggest certain statistical safeguards designed to make sure that the results of such a comparison have meaning. Given that the comparison stated does not appear to be the result of a study designed to elucidate "statistical significance," I am wary of drawing any conclusion one way or the other from this data.

Even if the data established that those in bankruptcy have higher credit card debts than those who are not, its not clear what that would prove. If it were true that credit card debt is correlated with bankruptcy filings, this would not prove that excessive credit card debt *caused* bankruptcy filings. For instance, high credit card debt might simply reflect reckless and irresponsible spending, in which case the spending would be a more plausible cause of bankruptcy than the credit cards. Obviously no conclusion could be drawn about the causal role of consumer debt in bankruptcy without adjusting for overall levels of home debt and multiple other factors. The theory is also lacking in a persuasive causal link between changes in the absolute level of credit card debt, as opposed to *current* debt levels that account for such variable and changes in the interest rate.

Question 10. You testified that "the credit card industry has revealed itself to be ferociously competitive."

Question (A). If that is the case, why have average interest rates on credit card hardly varied over the past 2 decades since the industry was functionally deregulated by the Marquette Supreme Court case, even though the cost of funds declined dramatically in this period?

As an initial matter, it is unclear to me what the term "hardly varied" means. Does it include very low "teaser" rates that many cardholders avail themselves of when they change cards? Without more information as to what that term means, it is difficult for me to even conclude that the factual predicate to the question is correct.

This question reflects several misunderstandings about the nature of the credit card market. As an initial matter, it is hard to imagine a market more competitive than the credit card market, which as of a recent count had 6,000 card issuers and millions of customers. The intense competition between card issuers to attract clients is probably best-evidenced by the massive volume of direct mail that card issuers send each year in an attempt to induce cardholders to shift from one card to another. As Brito and Hartley write, "Several authors . . . have argued that even though the market for bank credit cards is unregulated, has thousands of independent firms, many of them recent entrants, and has millions of consumers, it nevertheless appears to be noncompetitive." Indeed, the intense competition in the 1990s due to the entry of new issuers such as AT&T, Household and First USA, generated a precipitous loss of market share for the incumbent card issuers such as Bank of America, Chase, and others. Consider the following discussion from *Credit Card Management* magazine: "Issuers need look back no further than the onset of the 1990s for a textbook case of such an occurrence. At the time, money center banks were the dominant issuers, thanks to the resources brought on by their size. Despite their power, they have become lethargic, charging interest rates of 18.9% or 19.8% and $20 annual fees for plain-vanilla cards. When the speciality card issuers, such as Household, AT&T, and First USA, began shaking up the business with contrarian marketing strategies that eliminated annual fees, slashed interest rates, and offered cardholders rich rewards for using their cards, the money centers were not creative enough to counter the assault on their domain." Thus, it is evident from the basic market structure of the industry that the credit card market is highly competitive.

Looking to changes in interest rates is not a sensible way to try to gauge the competitiveness of the market. Card issuers have added many benefits to their cards in the past decade, ranging from the spread of "affinity" cards, to co-branded cards that give frequent flyer miles, to cash back bonuses in some cases. Looking only at interest rates and ignoring the benefits that have arisen would be comparable to saying that the automobile industry is noncompetitive because sometimes automobile manufacturers improve the quality of their product rather than simply cut-

ting the price. Such a conclusion would obviously be incorrect when applied to cars, and it is equally incorrect when applied to credit cards. Looking only at interest rates is also problematic in that ignore the serious adverse selection problems that would accompany a "low interest rate" marketing strategy; thus, issuers might be expected to increase benefits and decrease other fees rather than reducing interest rates in response to a fall in the cost of funds rate.

The question also overstates the role of the *Marquette* decision in the development of the credit card market. Usery regulations have been on the books throughout world history, and they have been easily circumvented throughout world history. The American experience is no different. Prior to *Marquette*, credit card issuers charged annual fees of $20 or $30 that were implicit compensation for the interest caps placed on credit cards. Of course, all customers were forced to pay this fee, even those who paid their bills every month. Similarly, retailers such as Sears were able to "hide" their interest rate losses in the prices of the goods they sold. The effect of the *Marquette* decision simply converted these hidden interest charges into more direct charges and allowed card issuers to target interest fees toward those who revolved balances rather than imposing them on everyone in the form of an annual fee. Focusing on interest rates ignores the reality that the almost complete elimination of annual fees during the past decade was really a *de facto* fall in the interest rate on credit cards.

There are other problems with looking at interest rates a proxy for competition in the credit card market. Because the vast majority of users are convenience users who pay their bills each month, they have little concern about credit card interest rates and would be willing to sacrifice the benefit of a lower interest rate in exchange for the elimination of an annual fee or the addition of an ancillary benefit such as frequent flyer miles. Thus, offering these benefits rather than an interest drop reflects competition. Focusing on the relationship between cost of funds and credit card interest rates is also misguided because it fails to account for the large "fixed costs" associated with credit cards, such as its much higher transaction costs due to the nature of credit cards as relatively small credit transactions. Finally focusing on interest rates reflects a fundamental misunderstanding of the consumer "demand" side of credit card transactions. I refer you to my article with Judge Jones for a further explanation of these issues, *see* Edith H. Jones and Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. Rev.

Question (B). Why have profits in the consumer credit consistently exceeded profits for all other lending activities?

This question is based on an incorrect factual predicate. Through the 1980s, returns for commercial credit were larger than for other sectors of banking activity. This was partly because returns to other sectors were artificially low due to passing problems such as a foreign debt crisis, energy sector borrowers, and commercial real estate markets, all of which struggled during the 1980s and early 1990s. It was also partly because the early issuers into the bank card market during the 1980s made unusually large profits that are typical in any major transitional period in an industry.

As applied in recent years, however, the question is simply incorrect in its factual predicate. In recent years, profit returns for consumer credit have been comparable to other sectors of the banking industry. Moreover, *risk-adjusted* profits are significantly lower, as credit card loans are riskier than other forms of credit; as a result, issuers maintain significantly higher average equity to asset and loan loss reserves to total loan ratios than for other operations. Finally, studies that purport to show disproportionate returns to consumer credit operations usually draw on an artificially limited sample of issuers that tends to ignore those issuers who have been losing money during this period. Thus, while it is true that until the early 1990s, consumer credit operations may have been higher than other sectors, since then those supranormal returns consumer credit operations is a myth.

Question 12. As further support for the proposition that the time has come for means testing, you testified: "Access to credit cards are especially important for low-income borrowers, as they lack the options of more wealthy borrowers." However, the means testing provision is one of dozens of changes to the consumer bankruptcy system in the pending legislation. Some of the provisions in the bill will decrease the amount of the debtor's income available for payment of unsecured debt in chapter 13, and in fact may further suppress the chapter 13 plan completion rate. How will these provisions affect the cost of unsecured credit and its availability for low income borrowers?

To the extent that means-testing reduces the financial losses associated with bankruptcy, ti will also reduce the overall "bankruptcy tax" paid by all Americans. Lower-income borrowers will benefit as well as everyone else.

Question 13. As a professor who has argued vigorously in favor of retaining disinterestedness requirements on chapter 11 debtors' lawyers to ensure that they act in their clients' best interests, do you believe it is appropriate for the bill to impose financial disincentives on lawyers to help their debtor clients file for chapter 7 if those lawyers believe that the debtor is an eligible candidate for chapter 7 and that it is in the best interest of the debtor to seek that relief?

It is not fully clear to me what "financial disincentive to file chapter 7s" is referenced in this question. I will assume that the question refers to the provisions that would require the debtor's counsel to reimburse the trustee for all reasonable costs and attorney's fees if the debtor's filing was not "substantially justified" and provisions for enforcing Rule 9011. If that is the case, it seems strange to refer to these ethical requirements as a "financial disincentive." Clearly these rules provide a financial disincentive for a debtor's attorney to file frivolous chapter 7 cases and to file cases where the debtor's lawyer fails to perform even a modicum of investigation into the debtor's financial affairs. Rule 9011 also gives a debtor's lawyer a financial disincentive to engage in fraudulent or other inappropriate activity, even if it is the client's best interests. The requirements of the proposed legislation require the debtor's lawyer to balance his ethical obligations to the debtor with his ethical obligations to the court and his fiduciary obligations to creditors. All lawyers balance these competing ethical obligations every day, and it is not clear why bankruptcy lawyers should be relieved of this obligation, or why it is useful to refer to ethical obligations as "financial disincentives to file chapter 7s" as opposed to "financial incentives to ensure that chapter 7 filings are made in good-faith and after reasonable investigation by the debtor's counsel."

Question 14. As a professor who has studied the bankruptcy system closely, do you see any creditor abuses in the system that should be addressed in bankruptcy reform legislation? If so, what are they?

To the extent there are creditor abuses in the system, they appear to have already been addressed or are addressed in H.R. 833. For instance, creditors who file false claims are already subject to punishment as are those who act illegally with respect to reaffirmations, as well-evidenced by the *Sears* case. Creditors are already subject to fee shifting for improper objections to discharge. There are additional debtor protections in the pending legislation. To the extent that creditors make ill-advised extension of credit to unworthy borrowers, the market will punish them through higher losses than their competitors. Finally, creditors that engage in abusive credit practices or overreach with their customers will find themselves disciplined through their customers switching to other credit issuers, different forms of credit, or substituting to non-credit alternatives, such as checks and cash.

PROFESSOR ELIZABETH WARREN'S RESPONSES

HARVARD LAW SCHOOL,
Cambridge, MA, March 26, 1999.

Hon. HENRY J. HYDE, *Chairman,*
Committee on the Judiciary,
House of Representatives, Washington, DC.

DEAR CONGRESSMAN HYDE: Thank you for providing me with the opportunity to appear before the Joint Hearing of the House Subcommittee on Commercial and Administrative Law and the Senate Subcommittee on Administrative Oversight and the Courts on Bankruptcy Reform on March 11, 1999.

Attached is my response to the questions posed by Senator Torricelli as followup questions to the Joint Hearing.

If there is any way in which I can be of further assistance, please let me know.

Very truly yours,

ELIZABETH WARREN,
Leo Gottlieb Professor of Law.

RESPONSES TO SENATOR TORRICELLI'S FOLLOWUP QUESTIONS

Effects on Women and Children

During 1997, an estimated 300,000 bankruptcy cases involved child support and alimony orders.[1] In about half of these case, women were *creditors* trying to collect alimony and child support from their bankrupt ex-husbands and others. In about half, women filed for bankruptcies themselves as they tried to stabilize their post-divorce economic condition. In the past five years, well over a million women collecting alimony and child support have been involved in bankruptcy cases.

Current law helps support recipients collect their debts after bankruptcy. It makes alimony and support obligations nondischargeable and provides a discharge of most other debts as long as they were not incurred fraudulently. The support provider emerges from bankruptcy economically stabilized and more easily able to meet ongoing support obligations and make up prebankruptcy support obligations. The pending legislation, largely supported by the credit card companies, makes more credit card debt nondischargeable and creates greater leverage for reaffirmation of unsecured and nominally secured debt (*e.g.*, retailer charge cards). There are only a limited number of dollars available for collection from ex-partners. These women face stiffer competition from credit card issuers who are trying to collect from the same people, whether or not the support recipients can rely on government agencies to help them enforce their rights.

In addition, may divorced women file for bankruptcy themselves to deal with crushing debts. These debts may have been incurred only by the ex-husband but are legal obligations of the ex-wife as well. Provisions making more debt nondischargeable and making bankruptcy less accessible will hurt every one of these women who turns to bankruptcy for some economic stability and relief from debts she did not incur.

Reaffirmations

Debtors should be free to repay debts if they so choose, whether or not those debts have been discharged, and they are free to do so under current bankruptcy law. However, the system currently permits debtors to bind themselves to repay those debts through reaffirmation agreements. Many reaffirmation agreements, even technically legal one, are the product of creditor coercion, are not voluntary, and are inconsistent with the purpose of chapter 7 debt relief. Currently, the law relies on attorney affidavits as evidence that debtors understand their rights and that the reaffirmation does not impose an undue hardship on the debtor and his family. The attorney affidavit approach has, for the most part, been a failure.

I attach letters from the Sears case, which are a matter of public record. These reaffirmations were illegal because Sears failed to file the agreements with the court. The tactics used to obtain these "voluntary" agreements that these debtors describe are not at issue. Every day, "legal" and "voluntary" reaffirmation agreements are filed with the court that will impose an undue hardship on the debtor and his family after bankruptcy.

It is easy to understand why a creditor wants the debtor to be legally bound to pay debts after bankruptcy, and why an emotionally and financially vulnerable debtor is convinced to comply. Given the dynamics of the situation, self-policing has not worked.

Pending bankruptcy legislation makes a bad situation worse. It is filled with provisions that give creditors additional leverage to pressure debtors to reaffirm debts and to increase the size of the reaffirmations to include more fees and charges. At the same time, it is devoid of provisions to offers meaningful protection for debtors pressed to make reaffirmations of unsecured and nominally secured debts.

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[1] The reported data are from Health and Human Services (support data) and the Consumer Bankruptcy Project, Phase II (bankruptcy data). Principal researchers for the bankruptcy data are Dr. Teresa Sullivan, Vice-President of the University of Texas, Professor Jay Westbrook, Benno Schmidt Chair in Business Law, University of Texas, and Elizabeth Warren, Leo Gottlieb Professor of Law, Harvard Law School. These estimates are based on data collected in 1991 in sixteen judicial districts around the country. For more details about the study, see Sullivan, Warren and Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981–91*, 68 AMERICAN BANKRUPTCY LAW JOURNAL 121 (1994). For a more detailed discussion of the divorce data see Sullivan, Warren, Westbrook, *Bankruptcy and the Family*, 21 MARRIAGE AND FAMILY REV. 193 (Haworth Press 1995). The data reported here will be discussed in fuller detain in Sullivan, Warren and Westbrook, THE FRAGILE MIDDLE CLASS (Yale University Press forthcoming 1999).

The Effects of Credit Cards on Personal Failure

The basic link between consumer debt (primarily short-term, high interest credit card debt) and bankruptcy has been demonstrated again and again. Studies by an economist at the Congressional Budget Office, the Federal Deposit Insurance Corporation, and independent economists link the rise in consumer bankruptcies directly to the rise in consumer debt.[2] The growth of credit card loans has been faster than any other type of consumer loans since 1993. Credit card debt doubled in just four years: The amount of credit card loans outstanding at the end of 1997 was $422 billion, twice as must as the amount in 1993.[3] The credit industry's own statistics support the hypothesis that people in bankruptcy have credit card debts substantially higher than the population at large. An MBNA representative testified on March 11, 1999 that bankcard debt alone is 16%of all debt in bankruptcy, including secured debt such as home mortgages. Assuming that this number is accurate, it is far higher than the percentage of credit card debt among total consumer credit outstanding—suggesting that credit card debt is an important trigger for bankruptcy.

Credit card usage has grown fastest in recent years among families with the lowest incomes. Since the early 1990s, Americans with incomes below the poverty level nearly doubled their credit card usage, and those in the $10,000–25,000 income bracket come in a close second in the rise in debt. The result is not surprising : 27% of the under-$10,000 families have consumer debt this is more than 40% of their income. Nearly one in ten has at least one debt that is more than sixty days past due.[4]

Subprime lending targets borrowers with poor credit records. Such lending has become the fastest growing, most profitable subset of consumer lending. Although losses are substantial, interest rates of 18 to 40% on credit card debt make this lending lucrative. In the subprime automobile finance market, by charging interest rates of 15% to 25% on secured car loans, several lenders have reported profit margins ranging from 23% to 41%.[5]

As card issuers target ever more vulnerable families, more people file for bankruptcy. Their path to bankruptcy is generally more complex than simply overspending on credit; when families' saving are being consumed by credit card debt, they are less able to withstand economic difficulties. A temporary job los, an uninsured medical bill, a divorce create financial stress; for the family already loaded with debt, the burden becomes unbearable.

Identifying the ling between debt and bankruptcy is not intended to impart "blame," but rather to show that lowering the bankruptcy filing rate and default rate, if these are Congress' goals, will not be accomplished by changing the bankruptcy laws. As long as the consumer credit industry continues to distribute large amount of credit to the most vulnerable sectors of the population and opposes requirements to disclose the true cost of open end credit, the bankruptcy filing rate and the default rate are not likely to decline.

Unintended Effects

The means test in H.R. 833 is designed to channel more high income debtors toward chapter 13 if they can pay a portion of their debts. This alone sounds relatively harmless, but is problematic for at least two reason. First, the means test not only screens *all* debtors, but it favors higher income debtors by giving them

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[2] Diane Ellis, Division of Insurance, FDIC, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-offs, and the Personal Bankruptcy Rate*, BANK TRENDS 98–05 (March 1998); Lawrence Ausubel, *Credit Card Default, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249 (1997); Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budge Office, before the Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, United States Senate, p. 4 (April 1997); Jagdeep S. Bhandari & Lawrence Weiss, *The Increasing Bankruptcy Filing Rate: A Historical Analysis*, 67 AM. BANKR. L.J. 1 (1993).

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

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

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

larger expense and debt allowances, particularly if they have bought a new car on the eve of bankruptcy. Thus, the means test in operation does not live up to its image. Second, the bill decreases the likelihood that a debtor will be able to repay creditors and discharge debts through a chapter 13 plan. For example, debtors would be required to make "adequate protection" payments to lessors and secured creditors at the same time they are paying all of their disposable income to the trustee; a debtor cannot make the same payments twice, and will have to surrender the property that he was trying to save through chapter 13. More debts would be considered "priority" debts and thus must be paid in full in the 5 year plan as a condition of confirmation, regardless of the size of those debts. Credit card debts would survive a five year repayment plan if declared nondischargeable, thus debtors would expend resources litigating nondischargeability that otherwise could be used to pay creditors. New treatment of undersecured debts would consume most debtors' disposable income and leave little or nothing for unsecured creditors. Making matters more complicated, the managers' amendment to H.R. 833 requires that chapter 13 payments be structured like the means test, even though the means test may still fail to take account of chapter 13 trustees' fees and back payments on secured debt. One is not even eligible for chapter 13 repayment plans unless she attempted consumer credit counseling within 90 days before filing.

There are two explanations for the conflicting messages in this bill. One is that the bill is at war with itself due to inadvertence. The second explanation is that this bill is not designed to increase distributions in chapter 13 but rather to make bankruptcy unworkable and altogether too expensive to be used by overburdened middle class American families. If that is the goal, it should be stated and accomplished directly rather than through this expensive piecemeal approach.

Other consequences, perhaps unintended, go far beyond the limits of the bankruptcy system. For example, some economists predict that making the consumer bankruptcy system more restrictive will increase risky lending and produce more defaults. In addition, one cannot underestimate the effect of business bankruptcy amendments. Many of the business provisions, such as those imposing absolute time limitations where there were once none, will have a tremendous effect on the out of court negotiations among various parties who bargained in contemplation of a different set of legal rules.

Stigma

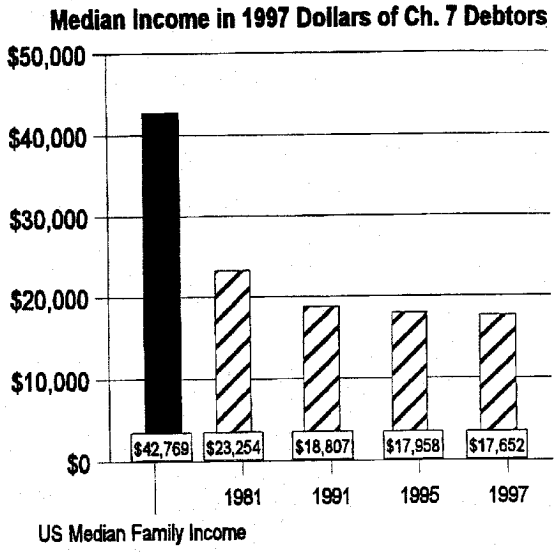
The consumer credit industry and others have blamed declining stigma for consumer failures for more than sixty years. In 1933, for example, it was the "ease of the bankruptcy laws" that attracted debtors who could pay said those who urged tightening the laws.[6] Those who want to blame rising bankruptcy filings on a lack of stigma ask us to believe the worst about middle class families in deep financial trouble.

If declining stigma were the reason for the increase in bankruptcy filings, we would expect the average family in bankruptcy to have an increasingly high income; more families in less trouble would say, "Why struggle so hard? Bankruptcy is an easy answer." However, the economic profile of debtors is not consistent with this theory. The median income of the debtors who have filed for Chapter 7 has been declining.[7] In inflation adjusted dollars, the average family in Chapter 7 in 1981 had an income of $23,254. By 1997, the average family in Chapter 7 had an income of $17, 652. Moreover, their debt-to-income ratios have worsened, not improved. If bankruptcy were easy, why wouldn't it be attractive to people in better shape—rather than being something people evidently avoid more now than ever before?

The data are collected in the table reproduced and attached to this answer.

[6] Victor Sadd & Robert T. Williams, *Causes of Bankruptcy Among Consumers* p. 5, 8, 11 (Washington GPO 1933).

[7] Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079 (Harris Lecture) (1998).



Source data cited in: Elizabeth Warren, *The Bankruptcy Crisis*, 73 IND. L.J. 1079 (Harris Lecture) (1998).

April 12, 1998

Sears Personal Bankruptcy Debtor Class Litigation
The Garden City Group, Inc. Settlement Administrator
P.O. Box 9439
Garden City, N.Y. 11530-9439

RE: FINAL REJECTION NOTICE INELIGIBLE CLAIM

CLAIM NO. 2037250

TO WHOM IT MAY CONCERN:

I totally disagree with the above determination based on the grounds listed below:

(1) Intimidation
(2) Coerced
(3) Fear
(4) Unknown
(5) My Lack of Knowledge

I will try my best to explain the above grounds.

Your letter states the Sears found the reaffirmation agreement was properly filed with the court. But what Sears didn't know was that the women representing Sears was very intimidating towards me.

I never filed bankruptcy before when I first walked into the room where the women from Sears was waiting for me, (before I went into the court room itself). While she was explaining the reaffirmation papers to me that she wanted me to sign, I truthfully wasn't paying attention because I was crying and so upset that I had failed to be able to pay my debts in the first place, (other wise I wouldn't have been in a backruptcy court).

The women from Sears used intimidation, my lack of knowledge, my fears of the unknown situation I was in, my lack of knowledge of these court room procedures and coerced me into signing those two (2) papers. I remember telling the women that I don't have $150.00 per month to pay for these two debts while I was signing the two papers for her. (Otherwise I wouldn't be filing backruptcy in the first place). I thought to myself when I get inside the court room I will explain this to the judge exactly what I have previously written, how the women from Sears made me sign the reaffirmation agreements, but the judge never brought up Sears to me in the court room proceedings. I remember thinking when I left the court room, "My Lord how am I going to pay this $150.00 to Sears each month.

Well I worked two full time jobs for almost seven years after my divorce with my seven children. The two full time jobs affected my health and I couldn't work them any more. That is when I stopped paying Sears the $150.00 a month. I also lost my home which I lived in for 25 years, so now I have nothing!

I pray someone will review my claim status and not find me ineligibl based on the above information.

Daphne Grantham
PO Box 144811
Austin Tx 78758

Claim No 2019823
April 9, 1998

Dear Settlement Administrator:

I filed bankruptcy to obtain a discharge of my debts owed to merchants. As you can see on my original worksheet Sears, was listed as an unsecured debt, which would have been discharged.

On March 6, 1997, at US Bankruptcy Court, West District of Tx, 903 San Jacinto suite 322, Austin, Tx, I ended up refirming a debt with Sears, even through the debt would have otherwise been discharged by the bankruptcy judge.

I was already emotional from having to attend my bankruptcy hearing. My lawyer said, a representive from sears would like to talk to me in the hallway. This representive said, I either had to return the bansaw, that was purchase on Dec 11, 1996, to clear my debt. I explain that I no longer had the bansaw. I was told if I didn't return it, since I no longer had it, I would have to sign a reaffirmation agreement. I feel I was coax into this agreement which, was not in my best interest. This was not a voluntary action on my part. This was a spur-of-the moment agreement in the hallway. I signed this agreement outside the bankruptcy court in the hallway, which could have been, discharged in the bankruptcy proceeding.

To reaffirm my unsecured debt provided no benefit to me, because I can obtain a credit card, secured by a deposit at less expense, then signing a reaffirmation agreement and paying back debt that could have been discharged.

The purpose of me filing bankruptcy was to obtain a discharge of my debt... So, instead of having a "fresh start" with the bankruptcy discharge, I have this old debt hanging over my head, which could have been discharged. I am now making payment on a debt that did not have to be reaffirmed.....

Sincerely,

Daphne Grantham

SRW

Sears Personal Bankruptcy Debtor Class Litigation
The Garden City Group, Inc., Settlement Administrator
P.O. Box 9439
Garden City, N.Y. 11530-9439
Toll Free: 1-(800)-529-4500

97-1222

Must be Postmarked by **August 24, 1998**

DISPUTE FORM

PLEASE READ THE FOLLOWING, FILL IN THE INFORMATION REQUESTED AND ATTACH THE DOCUMENTS REQUESTED, AND SIGN WHERE INDICATED.

CORRECTIONS: Write any name and/or address changes here:

Claim Number: 2022421 0017040174

ELIZABETH A LONG
P O BOX 9135
LAWAI HI 96765-0193

DOCKETED

Your Sears account number:

MAIL THIS COMPLETED FORM AND ALL ATTACHMENTS BEFORE AUGUST 24, 1998 TO BOTH ADDRESSES BELOW:

United States Bankruptcy Court District of Massachusetts, Eastern Division 10 Causeway St. Boston, MA 02116 Attention: Sears Settlement Dispute Hearings	The Garden City Group, Inc. Settlement Administrator P.O. Box 9439 Garden City, NY 11530-9439 Attention: Sears Settlement Dispute Hearings

Supporting Documents

Your claim may be in dispute because one or a number of documents necessary to prove an element of your claim is either missing or disputed. You should submit copies of all of the documents outlined below which you have. **NOTE:** If you have already submitted copies of these documents to the Settlement Administrator, you do not have to resubmit those documents now, although you may do so if you wish.

Check if Attached:

Proof of your Chapter 7 bankruptcy filing

- ☒ Order of discharge in your bankruptcy case.
- ☒ Other proof (such as Voluntary Petition, Notice of Case Commencement, docket sheet, or other documents).

Proof of your reaffirmation agreement with Sears

- ☒ Reaffirmation agreement with Sears.
- ☒ Sears billing statement from after your bankruptcy filing.
- ☒ Other proof (such as letters or other documents referring to post-bankruptcy payments to Sears).

Proof of your reaffirmation payments to Sears

- ☒ Billing statements (post-bankruptcy).
- ☒ Canceled checks, money orders, in-store payment receipts.
- ☒ Other proof

Description of Dispute

In the space below, describe the benefits you believe you are entitled to under the settlement, and why you believe you are entitled to them. If this form does not contain enough room to complete your written statement, attach additional sheets of paper containing your written statement to the form.

I feel I am entitled to receive a cash compensation benifit in the amount of $ 4,000.00 . Only the amount to pay off my debt which I had always wanted discharged. I never had any intentions of reaffirming my debt with Sears. The above amount also includes payments I have made since filing bankruptcy. I signed the reaffirmation agreement under duress and all but short of being coered, all taking place while court was in session!! Prior to court all verba

ADDITIONAL SPACE AND SIGNATURE ON THE OTHER SIDE

Description of Dispute - CONTINUED

In the space below, describe the benefits you believe you are entitled to under the settlement, and why you believe you are entitled to them. If this form does not contain enough room to complete your written statement, attach additional sheets of paper containing your written statement to the form.

and written correspondenced with my attorney pursuant to Sears was made quite clear that my choice was to return merchandise to Sears and have my debt discharged. Please see EXhibit "A", this form which my attorney asked me to fill out for all Creditors. As you can see I informed my attorney in writting that "NO" I do not wish to reaffirm Sears Debt. (My attorney's secretary gave me this copy from my file -post hearing.) I don't understand why Sear's even was permitted to approach me in court when I had already given my answer not to reaffirm.?? Plus I sat for at least 1/2 hour outside the courtroom doors where Sears (Lorraine) and my attorney could have approached me instead of while court was in session and I could not ask questions and was under DURESS! There was no need for Sears Lorraine to harass me in court they could have thereafter. When I wen back to my attorney and complained and ask to re-open my case. See exhibit "D" My attorney did inform me that Sears Lorraine no longer shows up in court and no longer harasses Debtors in court. (The whole reason for my filing was to wipe my slate clean an to start fresh.) My attorney then sent his response/Exhibit "E", discouraging me fr re-opening my case, rather refusing to do so, for he returned my check.

~~Getting back to what took place while court was insession please see exhibit~~ "B My attorney was runningback and forth to Lorraine from Sears he was ~~whispering~~ to me:" we can get these values down" I didn't know what he was getting at. Plus as you can see exhibit "B" states nothing about 21% interest either!! The next thing I know I am being called before the Trustee. Exhibit "B" was not present before the Trustee however exhibit "C" was presented and I was asked to sign. Exhibit "C" is different than exhibit "B" for Sears added in that "all of the terms and conditions as set forth in the origianl security agreement would resume. (Referring to interest etc.) This clearly was not understood or explained, nor presented in a professional manner. TO BE PRESENTED ALL OF THIS WHILE COURT IS IN SESSION WHEN YOU ARE NOT ABLE TO SPEAK FREELY, NOR WAS ANYTHING EXPLAINED IS SIMPLY UNFAIR. I was clearly under DURESS and all but short of being coered. I KNOW THIS IS UNACCEPTABLE PRACTICE FOR WHY HAS SEARS DISCONTINUED THIS PRACTICE?!! There is plenty of time prior to court or after court hearing. Sears is not soley at fault here , I feel my attorney is also at fault and should know bette and I hope someday his unethical practices will catch up with him! I am hoping justice can be served. I do feel ashamed for my debt, however there are laws and there are proper ways to conduct business and with all my heart I do not feel Sears (Lorraine) conducted business in a proper, fair manner!

Date: August 13, 1998 Signature of Claimant: Elizabeth A. Fay

SRW

Sears Personal Bankruptcy Debtor Class Litigation
The Garden City Group, Inc., Settlement Administrator
P.O. Box 9439
Garden City, N.Y. 11530-9439
Toll Free: 1-(800)-529-4500

97-1222

Must be Postmarked by **August 24, 1998**

DISPUTE FORM

PLEASE READ THE FOLLOWING, FILL IN THE INFORMATION REQUESTED AND ATTACH THE DOCUMENTS REQUESTED, AND SIGN WHERE INDICATED.

CORRECTIONS: Write any name and/or address changes here:

Claim Number: 2056337 2288125113

new address:
8657 Bell Dr
Atwater CA 95301

KEVIN MURPHY
2037 GLEN EAGLE ST
ATWATER CA 95301

DOCKETED

Your Sears account number:

MAIL THIS COMPLETED FORM AND ALL ATTACHMENTS BEFORE AUGUST 24, 1998 TO BOTH ADDRESSES BELOW:

United States Bankruptcy Court District of Massachusetts, Eastern Division 10 Causeway St. Boston, MA 02116 Attention: Sears Settlement Dispute Hearings	The Garden City Group, Inc. Settlement Administrator P.O. Box 9439 Garden City, NY 11530-9439 Attention: Sears Settlement Dispute Hearings

Supporting Documents

Your claim may be in dispute because one or a number of documents necessary to prove an element of your claim is either missing or disputed. You should submit copies of all of the documents outlined below which you have. **NOTE:** If you have already submitted copies of these documents to the Settlement Administrator, you do not have to resubmit those documents now, although you may do so if you wish.

Check if Attached:

Proof of your Chapter 7 bankruptcy filing

- ☒ Order of discharge in your bankruptcy case.
- ☒ Other proof (such as Voluntary Petition, Notice of Case Commencement, docket sheet, or other documents).

Proof of your reaffirmation agreement with Sears

- ☐ Reaffirmation agreement with Sears.
- ☐ Sears billing statement from after your bankruptcy filing.
- ☐ Other proof (such as letters or other documents referring to post-bankruptcy payments to Sears).

Proof of your reaffirmation payments to Sears

- ☒ Billing statements (post-bankruptcy).
- ☒ Canceled checks, money orders, in-store payment receipts.
- ☐ Other proof

Description of Dispute

In the space below, describe the benefits you believe you are entitled to under the settlement, and why you believe you are entitled to them. If this form does not contain enough room to complete your written statement, attach additional sheets of paper containing your written statement to the form.

I would like to begin by saying I'm sending you copies of all the billing statements I could find + copies of the cancelled checks. We have no cancelled checks from the time we lived in Florida due to the bank held them by our request. I'm not sure how we could get copies at this point. Now on the day we went to the bankruptcy hearing we were approached by a woman from Sears She explained to

ADDITIONAL SPACE AND SIGNATURE ON THE OTHER SIDE

281

Description of Dispute - CONTINUED

In the space below, describe the benefits you believe you are entitled to under the settlement, and why you believe you are entitled to them. If this form does not contain enough room to complete your written statement, attach additional sheets of paper containing your written statement to the form.

us who she was. At the time I (Debra) was due in two weeks to give birth. The woman told us that we needed to either pay our bill in full or return items such as sofa, washing machine + vacuum. We weren't going to the hearing because we had mon and we couldn't afford to replace these items which we needed. We explained these things and found our attorney. The woman then said that we could keep the items if we signed a paper saying we would continue making payments and that the payments would never exceed $62.00 a month. We signed of course. The woman then left the building and shortly after we went into the hearing. When the judge asked if any creditor was there, there were none. Everything was discharged. This was late afternoon and Debra went into labor and was taken to the hospital. She gave birth early the following morning. Now, we later received papers from the court and received only 1 reaffirmation agreement from the court, but it was not from Sears. Now we don't believe Sears did file the papers we signed. But, if they did, the agreement on them was the payment was not to exceed $62.00, but as you can see on the statements it eventually did. If I had had copies of a reaffirmation agreement I would have used that with Sears to not allow our payments to change. Also the woman bullied us into signing papers and the stress of this bought on my wifes labor. We due feel we are entitled to cash compensation for several reasons of which are: ① We were bullied into signing papers ② We don't believe the papers were properly filed as we never received any copy pertaining to this and we saved all papers we received that was related in any way to the bankruptcy, and ③ our payments were not to exceed $62.00 a month and they eventually did.

Date: 7-27-98 Signature of Claimant: [signature]

97-1222

December 1, 1998

Clerk
United States Bankruptcy Court
1101 Federal Office Building
10 Causeway Street
Boston, Massachusetts 02222-1074
Attention: Sears Claim Dispute Notice

DOCKETED

To whom it may concern:

After reviewing Sears' copy of the reaffirmation agreement, I disagree with their decision that I should not be included in this class action case.

If Sears did file this agreement with the court, it was filed under false pretenses, and was agreed upon under blackmail type circumstances. I was not aware of bankruptcy legalities and did not understand that when Sears threatened that, if I did not sign the agreement, they would repossess purchases that I had made at Sears, such as tires on my car. I did not understand at that time, that this was just a threat.

If, in fact, the agreement was filed with the Court, as Sears states, the information in the agreement has not been upheld by Sears. The agreement states that a payment of $39.00 per month will be paid until the balance is paid in full. Each month, I am billed a minimum payment (Less than $39.00). Not only is the payment amount incorrect, I feel this was done to allow Sears to collect additional interest.

Since we have been disputing this agreement with Sears, an amount of $122.00 has been deducted from our balance. When we asked for explanation for the deduction from Sears, we were told that interest charged during the reaffirmation agreement was not legal and, therefore, Sears deducted the $122.00. However, interest paid over the years on my balance has not been deducted.

For all these reasons, I feel that I am a part of this class action. If it is necessary to have a hearing on this matter, I would like to appear at the hearing by telephone on February 11, 1998. Please notify me of the outcome, as well as the hearing date and time if applicable.

Sincerely, Bruce A Rose
Barbara Rose

Bruce A. Rose
Barbara Rose
8216 Lanyard Drive
Parma, Ohio 44129
(440) 884-3057

cc:

Mark N. Polebaum, Esq.
Heidi C. Paulson, Esq.
Hale and Dorr LLP
60 State Street
Boston, MA 02109

Frederic D. Grant, Jr., Esq.
John Roddy, Esq.
Grant & Roddy
44 School Street, Suite 400
Boston, MA 02108-4200

533

SRW

Sears Personal Bankruptcy Debtor Class Litigation
The Garden City Group, Inc., Settlement Administrator
P.O. Box 9439
Garden City, N.Y. 11530-9439
Toll Free: 1-(800)-529-4500

97-1222

Must be Postmarked by **August 24, 1998**

DISPUTE FORM

PLEASE READ THE FOLLOWING, FILL IN THE INFORMATION REQUESTED AND ATTACH THE DOCUMENTS REQUESTED, AND SIGN WHERE INDICATED.

CORRECTIONS: Write any name and/or address changes here:

Claim Number: 2022421 0017040174

DOCKETED

ELIZABETH A LONG
P O BOX 9135
LAWAI HI 96765-0193

Your Sears account number:

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Description of Dispute

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I feel I am entitled to receive a cash compensation benifit in the amount of $ 4,000.00 . Only the amount to pay off my debt which I had always wanted discharged. I never had any intentions of reaffirming my debt with Sears. The above amount also includes payments I have made since filing bankruptcy. I signed the reaffirmation agreement under duress and all but short of being coered, all taking place while court was in session!! Prior to court all verba

ADDITIONAL SPACE AND SIGNATURE ON THE OTHER SIDE

Description of Dispute - CONTINUED

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and written correspondenced with my attorney pursuant to Sears was made quite clear that my choice was to return merchandise to Sears and have my debt discharged. Please see EXhibit "A": this form which my attorney asked me to fill out for all Creditors. As you can see I informed my attorney in writting that "NO" I do not wish to reaffirm Sears Debt. (My attorney's secretary gave me this copy from my file -post hearing.) I don't understand why Sear's even was permitted to approach me in court when I had already given my answer not to reaffirm.?? Plus I sat for at least 1/2 hour outside the courtroom doors where (Sears/Lorraine) and my attorney could have approached me instead of while court was in session and I could not ask questions and was under DURESS! There was no need for Sears/Lorraine to harass me in court they could have thereafter. When I wen back to my attorney and complained and ask to re-open my case. See exhibit "D" My attorney did inform me that Sears/Lorraine no longer shows up in court and no longer harasses Debtors in court. (The whole reason for my filing was to wipe my slate clean an to start fresh.) My attorney then sent his response/Exhibit "E", discouraging me fr re-opening my case, rather refusing to do so, for he returned my check.

~~Getting back to what took place while court was insession please see exhibit~~ "B My attorney was runningback and forth to Lorraine from Sears he was ~~willsparing~~ to me:" we can get these values down" I didn't know what he was getting at. plus as you can see exhibit "B" states nothing about 21% interest either!! The next thing I know I am being called before the Trustee. Exhibit "B" was not present before the Trustee however exhibit "C" was presented and I was asked to sign. Exhibit "C" is different than exhibit "B" for Sears added in that: "all of th terms and conditions as set forth in the origianl security agreement would (Referring to interest etc.) resume. This clearly was not understood or explained, nor presented in a professional manner. TO BE PRESENTED ALL OF THIS WHILE COURT IS IN SESSION WHEN YOU ARE NOT ABLE TO SPEAK FREELY, NOR WAS ANYTHING EXPLAINED IS SIMPLY UNFAIR. I was clearly under DURESS and all but short of being coered. I KNOW THIS IS UNACCEPTABLE PRACTICE FOR WHY HAS SEARS DISCONTINUED THIS PRACTICE?!! There is plenty of time prior to court or after court hearing. Sears is not soley at fault here , I feel my attorney is also at fault and should know bett and I hope someday his unethical practices will catch up with him!

I am hoping justice can be served. I do feel ashamed for my debt, however there are laws and there are proper ways to conduct business and with all my heart I do not feel Sears (Lorraine) conducted business in a proper, fair manner!

Date: August 13, 1998 Signature of Claimant: Elizabeth A Fay

SRW

Sears Personal Bankruptcy Debtor Class Litigation
The Garden City Group, Inc., Settlement Administrator
P.O. Box 9439
Garden City, N.Y. 11530-9439
Toll Free: 1-(800)-529-4500

97-1222

Must be Postmarked by **August 24, 1998**

DISPUTE FORM

PLEASE READ THE FOLLOWING, FILL IN THE INFORMATION REQUESTED AND ATTACH THE DOCUMENTS REQUESTED, AND SIGN WHERE INDICATED.

CORRECTIONS: Write any name and/or address changes here:

Claim Number: 2056337 2288125113

KEVIN MURPHY
2037 GLEN EAGLE ST
ATWATER CA 95301

DOCKETED

Your Sears account number:

new address:
8657 Bell Dr
Atwater CA 95301

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Date: 7-27-98 Signature of Claimant: [signature]

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

UNITED STATES OF AMERICA,	)	
	)	
v.	)	**CRIMINAL NO.**
	)	
SEARS BANKRUPTCY RECOVERY MANAGEMENT SERVICES, INC., Defendant	)	**VIOLATION: 18 U.S.C. §157 (Bankruptcy Fraud)**

INFORMATION

THE UNITED STATES ATTORNEY CHARGES:

A. INTRODUCTION

1. At all times relevant to this Information, SEARS, ROEBUCK AND CO. ("SEARS") was headquartered in Illinois and doing business throughout the United States, including in Massachusetts. The business of SEARS includes retail sales of home furnishings, clothing, appliances, and the like.

2. As part of its business, SEARS, through its credit business and another wholly-owned subsidiary, granted credit and issued SEARS credit cards to some of its customers for the purchase of goods and services at SEARS' stores. SEARS' credit business had approximately 10,000 employees. At all times relevant to this Information, the portion of the credit business performing the bankruptcy recovery function ("SEARS' Recovery Unit"), handled the business of trying to recover monies from SEARS' credit card customers who had filed for bankruptcy. SEARS was a creditor in those bankruptcy proceedings.

3. At all times relevant to this Information, defendant

SEARS BANKRUPTCY RECOVERY MANAGEMENT SERVICES, INC. ("SEARS BANKRUPTCY") was a wholly-owned subsidiary of SEARS. SEARS BANKRUPTCY was formerly known as SEARS Finance Corporation. As of the date of this Information, SEARS BANKRUPTCY has acquired substantially all of the assets and has assumed liabilities relating to SEARS' Recovery Unit, and has entered into a written contract with SEARS to provide bankruptcy recovery services.

B. **THE BANKRUPTCY PROCESS**

4. A bankruptcy case is begun when a person files a bankruptcy petition. The principal benefit to the debtor from filing for bankruptcy is the discharge of his or her debts. When the bankruptcy court grants a debtor a discharge of debts, all of the creditors listed in the bankruptcy are prohibited from taking any collection action against the debtor for pre-bankruptcy debts.

5. Despite the bankruptcy discharge, a debtor may choose to make payments voluntarily to pre-bankruptcy creditors. However, a creditor may not take any steps to try to collect on those pre-bankruptcy debts, including conditioning new loans, future services or business relationships on the repayment of the discharged debts.

6. A debtor may also choose to enter into what is known as a "reaffirmation agreement" with a creditor. Such agreements have the effect of legally obligating the debtor on a debt or a portion of a debt which would otherwise have been discharged through his or her bankruptcy.

7. In order for a reaffirmation agreement to be effective, the debtor and creditor must comply with all the requirements set forth in the Bankruptcy Code concerning the reaffirmation of debt. If the requirements are not met, the reaffirmation agreement is of no effect and the debts listed in it are discharged along with all others.

8. One requirement of all reaffirmation agreements is that they be filed with the Bankruptcy Court.

9. Another requirement for all reaffirmation agreements entered into by debtors who do not have lawyers representing them is that the Bankruptcy Court hold a hearing, at which the Bankruptcy Court is required to advise the debtor of the effects of the reaffirmation agreement, and make an independent determination that the reaffirmation agreement does not impose an undue hardship on the debtor or a dependent of the debtor and that it is in the debtor's best interest.

10. The purpose of the filing and hearing requirements is so the Bankruptcy Court can maintain oversight over reaffirmation agreements entered into by debtors. Specifically, these requirements are designed to protect debtors from being coerced into signing such agreements and to assure that they fully understand the consequences of such agreements.

C. **THE SCHEME TO DEFRAUD**

11. Beginning in or about 1985, and continuing until in or about April, 1997, in the District of Massachusetts and elsewhere, the defendant herein,

SEARS BANKRUPTCY RECOVERY MANAGEMENT SERVICES, INC.

did devise and intend to devise a scheme and artifice to defraud and to obtain money and property by means of false and fraudulent pretenses, representations and promises.

12. The scheme consisted of inducing some bankruptcy debtors to enter into "reaffirmation agreements" and leading such debtors to believe that the agreements would be filed with the bankruptcy court and were binding contractual obligations, when in fact SEARS' Recovery Unit knew that it was not going to file such agreements and that the debtors had no obligation to pay the otherwise discharged debt.

13. The scheme began in response to an increased volume of bankruptcy filings by SEARS' credit card customers, and SEARS' perception that some bankruptcy judges were hostile to it and/or to reaffirmation agreements.

14. In furtherance of this scheme, SEARS and its Recovery Unit did, among other things, the following:

a. Established a nationwide program in which it sought to obtain reaffirmation agreements from most debtors who filed for bankruptcy and owed SEARS money.

b. Used a SEARS' reaffirmation agreement form that represented directly and by implication that it would be filed with a

Bankruptcy Court. The typical form agreement used by SEARS' Recovery Unit was in the form of a bankruptcy court pleading, with a standard court heading of "In the United States Bankruptcy Court for the ____ District of _____." The standard form also informed the debtor that he or she had the right to rescind it prior to discharge or within a certain period "after this agreement is filed with the court." At the bottom of each such form agreement was a section entitled "Order Approving Reaffirmation Agreement" and a line for a bankruptcy court judge to sign.

c. Did not inform debtors that the agreement was not to be filed with the Bankruptcy Court or that any payments under such agreement were entirely voluntary on the part of the debtor and could be stopped at any time without SEARS having any legal ability to enforce the reaffirmation agreement . Nothing in the form reaffirmation agreement indicated that payments by debtors under the agreement were being made on a purely voluntary basis.

d. Misled debtors to believe that the reaffirmation agreement was a binding contractual obligation to pay a debt to SEARS, when in fact the debt was going to be discharged. The reaffirmation agreement form used by SEARS' Recovery Unit stated that the debtor "reaffirm[s], promise[]s and agree[s]" to pay SEARS; that upon default of any one installment, "the entire balance set forth above, with finance charges shall be due and payable immediately;" and

debtor "promises, reassumes and agrees to be bound by all the terms and conditions as set forth in the original security agreement" with SEARS.

e. In some situations, SEARS' Recovery Unit failed to obtain a written reaffirmation agreement from debtors, but instead obtained an oral agreement to continue paying the debt. SEARS led debtors to believe such oral agreements were also binding contractual agreements, and sent account statements and made follow-up telephone calls to induce debtors to pay.

f. To further mislead debtors into believing they had an obligation to pay the discharged debt to SEARS, after obtaining the signed reaffirmation agreements, SEARS regularly sent monthly bills to such debtors.

g. To further mislead debtors into believing they had an obligation to pay the discharged SEARS' debt, SEARS would place telephone calls to those debtors who stopped paying after signing the reaffirmation agreements to find out if they intended to pay.

h. In some circumstances, SEARS would even initiate legal actions to recover both post-petition and pre-petition debt, assuming that the debtor would not know the reaffirmation agreement had not been filed and therefore, was not legally binding and enforceable.

i. SEARS instituted a nationwide training program consisting of a written manual and oral presentations, both of which counseled against filing reaffirmation agreements in certain

circumstances, including when the particular bankruptcy judge was known to regularly reject such agreements, when the debt involved was primarily unsecured, and when the debtor involved was not represented by an attorney.

15. The policy and practice of not filing reaffirmation agreements where bankruptcy judges were unlikely to approve them was known and approved of by some now former senior personnel in SEARS' credit business, as well as some now former lawyers in SEARS' legal department.

16. The written policy was drafted by personnel in SEARS' credit business and SEARS' legal department. It was distributed nationwide. It was reinforced during bankruptcy training seminars conducted jointly by members of the credit business and legal department.

17. As a result of this fraudulent scheme, SEARS obtained millions of dollars on discharged debts to which it had no legal right from thousands of debtors nationwide, including in Massachusetts.

D. **COUNT 1 - BANKRUPTCY FRAUD (18 U.S.C. §157)**

18. Paragraphs 1-17 of this Information are realleged and incorporated herein.

19. On or about June 14, 1995, in the District of Massachusetts, the defendant

SEARS BANKRUPTCY RECOVERY MANAGEMENT SERVICES, INC.,

having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so, as set forth above, did make false and fraudulent representations, claims and promises concerning and in relation to a proceeding under Title 11 (the Bankruptcy Code), specifically the following bankruptcy case:

1. In re: Michael J. Halchuk, case number 95-13062, filed on or about May 3, 1995, in the U.S. Bankruptcy Court for the District of Massachusetts in Boston.

All in violation of Title 18, United States Code, Sections 157 and 2.

DONALD K. STERN
United States Attorney

By: _____
MARK J. BALTHAZARD
Assistant U.S. Attorney