

# CRS Report for Congress

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## Issues in Consumer Bankruptcy Reform

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### Summary

This report examines several issues that have been prominent in the debate over consumer bankruptcy reform during the last two congresses. They are the focus of congressional debate once again in the 107<sup>th</sup> Congress. Issues considered include the proposal to impose a federal cap on the bankruptcy homestead exemption; amending the Bankruptcy Code to make liability incurred in connection with violence at reproductive health clinics nondischargeable; the effect of bankruptcy reform on debtors' child support obligations; and the linkage of the treatment of credit card debt in bankruptcy to credit marketing and lending practices under the Truth in Lending Act. This report will not be updated.

**Background.** Shortly before the close of the first session of the 105<sup>th</sup> Congress – and shortly before the National Bankruptcy Review Commission issued its report recommending changes to the law<sup>1</sup> – legislation was introduced to dramatically change the manner in which consumer bankruptcies are administered under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.* Legislation came close to passage in both the 105<sup>th</sup> and 106<sup>th</sup> Congresses. Shortly before the close of the 106<sup>th</sup> Congress, bankruptcy reform passed both chambers. President Clinton withheld his approval, Congress adjourned *sine die*, and the bill was “pocket” vetoed.<sup>2</sup>

The reform bills of the last several congresses have been comprehensive. In addition to consumer bankruptcy, they encompass titles addressing small business and general business bankruptcies, including bankruptcy tax provisions. However, in contrast to consumer bankruptcy, the ability of businesses to file has not generated the legislative impetus to contain their numbers. Hence, the proposed amendments to business-related bankruptcies are more consistent with traditional bankruptcy practice and have been somewhat less controversial. Some critics have suggested, however, that proposed business-related amendments, particularly those relating to small business and single-asset

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<sup>1</sup> “Bankruptcy: The Next Twenty Years,” National Bankruptcy Review Commission Final Report (Government Printing Office, October 20, 1997).

<sup>2</sup> The conference report to H.R. 2415, 106<sup>th</sup> Congress, 2d Sess. (2000) passed by the House by a voice vote, and the Senate by a vote of 70 to 28.

bankruptcies may be particularly burdensome to effective reorganization if an economic downturn drives up business bankruptcy filings.

**Legislative Goals of Consumer Reform.** The high volume of consumer bankruptcy filings during the 1990's fuels the argument that the current law is too lenient, *i.e.*, “debtor-friendly.” Proponents of consumer bankruptcy reform cite many reasons in its support. The legislation is intended, among other things, to make filing more difficult and thereby thwart “bankruptcies of convenience”; to revive the social “stigma” of a bankruptcy filing; to prevent bankruptcy from being utilized as a financial planning tool; to determine who can pay their indebtedness and to ensure that they do; to lower consumer credit interest rates; and, to maximize the distribution to both secured and unsecured creditors. To effect these goals, the proposals implement a “means test” to determine consumer debtors’ eligibility to file under chapter 7.

Opponents argue that making it more difficult to file will undermine the rehabilitative purpose of bankruptcy and have a disparate impact on financially less sophisticated debtors. They believe that there is insufficient evidence of pervasive abuse to warrant major revisions to bankruptcy law. Studies attempting to estimate the increase in creditor recovery as a result of means testing are hypothetically-based and somewhat inconclusive.<sup>3</sup>

**The Pocket Veto.** The White House *Memorandum of Disapproval* explaining President Clinton’s decision to veto H.R. 2415, the Bankruptcy Reform Act of 2000, at the conclusion of the 106<sup>th</sup> Congress cites two primary criticisms of the Act: first, retention of the unlimited homestead exemption and second, omission of the provision from the Senate-passed version making nondischargeable liability incurred as a result of violence at reproductive health care clinics.<sup>4</sup> These issues remain controversial as bankruptcy reform is considered by the 107<sup>th</sup> Congress. They are discussed below.

### **Issues Historically Surrounding Consumer Bankruptcy Reform.<sup>5</sup>**

**The Homestead Exemption.** The U.S. Bankruptcy Code, by design, is *not* an equalizer of wealth among all bankruptcy debtors. Each bankruptcy is highly fact specific; but as a general proposition, a debtor who enters bankruptcy with more wealth is likely to emerge from it with more. Any disparity in the outcome among consumer bankruptcy debtors is, in large part, a function of the bankruptcy system of exclusions and exemptions.

Bankruptcy exclusions and exemptions allow debtors to remove specified assets from the reach of creditors. Implicit in the concept of exemptions is the notion that a debtor must have some resources to pursue his or her “fresh start,” and that no one would undertake bankruptcy voluntarily if it rendered him or her destitute.

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<sup>3</sup> General Accounting Office, *Personal Bankruptcy: Analysis of Four Reports on Chapter 7 Debtors’ Ability to Pay*, GAO/GGD99-103 (June 1999).

<sup>4</sup> H.R. 833, 106<sup>th</sup> Congress, 2d Sess. § 328 (2000).

<sup>5</sup> For a discussion of active legislation before the 107<sup>th</sup> Congress, see CRS Report RL30865, “Bankruptcy Reform Legislation in the 107<sup>th</sup> Congress: A Comparison of H.R. 333 As Passed by the House and Senate.”

Debtors may choose between exemptions established in the Bankruptcy Code, 11 U.S.C. § 522, and those established under state law. Congress requires not just that the debtor make an election between federal and state created exemptions, but permits the states to deny debtors the use of – or “opt out” from – federal exemptions. The creation of this program – like the decision to refrain from conferring Article III status on bankruptcy judges – was part of the legislative compromise that facilitated passage of the current law.<sup>6</sup> Consequently, even though there is a significant variance among the states in the generosity of their exemptions, more than half have enacted laws that deny debtors the use of federal exemptions.<sup>7</sup>

In states where federal exemptions are not permitted, the debtor is limited to exemptions under applicable state law and nonbankruptcy federal statutes. The amount and value of state law exemptions vary enormously. Among the best-known are those states with homestead exemptions of unlimited monetary value.<sup>8</sup> Media attention has focused on wealthy debtors who establish prebankruptcy residency in a state with a generous homestead exemption. Thus, when Bowie Kuhn and Harvey Meyerson established homesteads in Florida for \$1 million and \$1.75 million respectively, observers pointed to the ease with which debtors abuse the bankruptcy laws.<sup>9</sup> But these anecdotal illustrations of “abuse” are the result of a deliberate congressional decision to permit states to limit their residents to state law exemptions, and of the deliberate statutory policy of various states to permit, for whatever reason, residents to avail themselves of an unlimited homestead exemption.

The breadth of the homestead provision in Florida was recently articulated by the State Supreme Court. In *Havoco of America v. Hill*,<sup>10</sup> the Supreme Court of Florida responded to a certified question from the Eleventh Circuit Court of Appeals and held that a debtor who converts nonexempt assets into an exempt homestead with the specific intent to hinder, delay, or defraud creditors is nevertheless a qualified beneficiary of the Florida homestead exemption. The court explained that the State Constitution recognizes only *three* exceptions to the exemption: payment of taxes on the property; contractual obligations for the purchase, improvement or repair of the property; and, contractual obligations for house, field or other labor performed on the realty. Nor could Florida’s fraudulent conveyance law expand or limit the scope of the homestead exemption.

The court was “loathe” to provide constitutional sanction to the debtor’s use of the exemption to shield his assets from creditors, but viewed the state constitutional provision as “unqualified.”

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<sup>6</sup> The opt-out program for exemptions was one of many compromises between the Senate, which advocated retaining exemptions under state law, and the House, which enacted a bill premised on federal exemptions. See, Kenneth N. Klee, *Legislative History of the Bankruptcy Reform Act of 1978*, in ANNUAL SURVEY OF BANKRUPTCY LAW 21 (Callaghan & Co. 1979).

<sup>7</sup> WILLIAM HOUSTON BROWN ET AL., BANKRUPTCY EXEMPTION MANUAL §3.02 (1999Ed.)

<sup>8</sup> Homestead exemptions in Florida, Iowa, Kansas, South Dakota, and Texas are of unlimited monetary value.

<sup>9</sup> Tim Nickens, *Limiting Debtor Luxury*, THE HERALD, March 30, 1994 at 3A..

<sup>10</sup> 2001 Fla. LEXIS 1237 (Fla. June 21, 2001).

These [constitutional] exceptions are unqualified. They create no personal qualification touching the moral character of the resident nor do they undertake to exclude the vicious, the criminal, or the immoral from the benefits so provided. The law provides for punishment of persons convicted of illegal acts, but this forfeiture of homestead rights guaranteed by our Constitution is not part of the punishment.<sup>11</sup>

*The reform bills.* Historically, there has been tension between proponents of states rights realized through the opt out system and those who view the disparities it creates as degrading the uniformity and equity of a national bankruptcy system.

The conflicting views are a prime subject of debate in connection with past and current reform proposals. Although Senate-passed legislation during the 106<sup>th</sup> Congress would have imposed a firm \$100,000 cap on exemptible home equity, that provision was omitted from the final bill. The bill also allowed a debtor to exempt up to one million dollars in pension assets. Hence, the proposed consumer reform would still have permitted debtors potentially to exempt millions of dollars from their bankruptcy estates. Although this scenario is rare, it is consistent with current law. Critics of the legislation – many of whom may be critics of the current opt out system – argue that it would be even more inappropriate in light of means testing. The means test formula would be implemented to block access to chapter 7 to debtors of average means and/or to require them to undertake chapter 13 reorganization plans that require them to live on a budget based on Internal Revenue Service national and local living standards for three to five years. Imposing strict new standards on asset-poor wage earners while permitting asset-rich ones to continue to shelter wealth in bankruptcy remains controversial.

This controversy has indeed been revisited in the 107<sup>th</sup> Congress. The House version of bankruptcy reform has lengthened residency requirements and a \$100,000 limit on homestead exemptions for a debtor who acquires the exemption by moving from one state to another within two years of the filing. The Senate-passed bill, however, has a firm, across-the-board federal cap of \$125,000. Although President Bush has generally favored the reform legislation and is expected to sign it if enacted, the White House has indicated that a bill containing a federal cap on homestead exemptions may be unacceptable.

***Nondischargeability for liability incurred in connection with violence at reproductive health clinics.*** During the 106<sup>th</sup> Congress, the Senate adopted an amendment sponsored by Sen. Schumer to prevent the discharge in bankruptcy of liability incurred as a result of violence at abortion clinics.

Critics of the provision argued that it was unnecessary in light of the Freedom of Access to Clinic Entrances Act (FACE), 18 U.S.C. § 248, the primary federal law addressing violence at abortion clinics. FACE provides both criminal penalties and civil liability for anyone who *intentionally* interferes with or injures someone attempting to access a reproductive health facility, or causes damage to the facility itself. The U.S. Bankruptcy Code, at 11 U.S.C. § 523(a)(6), prohibits discharge of debts “for willful and malicious injury by the debtor to another entity or to the property of another entity[.]” It is suggested that FACE and 11 U.S.C. § 523(a)(6) operate in tandem sufficiently to

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<sup>11</sup> Id. at 9.

prevent bankruptcy discharge of liability for abortion clinic violence. Furthermore, there is scant reported case law sanctioning discharge of this kind of debt.

Sen. Schumer, however, gave several examples of individuals who filed in bankruptcy to avoid payment of judgments for anti-abortion related violence.<sup>12</sup> Proponents of the provision noted that every individual's bankruptcy does not lead to a reported decision. They asserted that the language of the nondischargeability provision in the bankruptcy bill was far broader than the above-cited statutes. It covered federal and state judgments, orders, decrees and settlement agreements that create debt for a violation of the FACE Act; a violation of *any* federal, state, or local law designed to protect access to health care facilities and/or provision of reproductive health services; a violation of any law, including federal civil rights laws, which results from harassment or intimidation of individuals attempting to provide or receive health services, or causes damage to a health care facility; or, a violation of a court order or injunction issued to protect access to a covered facility. The activities that were the source for nondischargeable liability under the amendment did *not* have a specific intent requirement for nondischargeability as required by 11 U.S.C. § 523(a)(6). And the existence of the requisite intent did not need to be litigated, making it easier for victims who are judgment-creditors to protect the nondischargeable status of their claim.

In the 107<sup>th</sup> Congress, the Senate-passed version contains a successor provision to that of the 106<sup>th</sup> Congress. The provision is not limited to reproductive health services. It is entitled “Nondischargeability of debts incurred through violations of law relating to the provision of lawful goods and services,”<sup>13</sup> but its intent, and the debate surrounding it, encompass the same elements as its predecessor.

***Protection of child support.*** Concern has been expressed about the impact of the proposed changes in consumer bankruptcy on the ability of debtors as parents to meet and maintain child and family support obligations. All previous versions of the legislation in the 106<sup>th</sup> Congress, as well as those in the 107<sup>th</sup>, make domestic support obligations a top priority. Indeed, the bills would elevate child support from seventh to first priority under 11 U.S.C. § 507(a), replacing administrative expenses.<sup>14</sup> While this change is intended to signal the importance that Congress places on the payment of child support (within and without bankruptcy), bankruptcy professionals have indicated that subordinating administrative expenses to child support may have the unintended effect of diminishing the trustee's ability to marshal the assets and collect the funds to pay the support obligation.

Nevertheless, child support and alimony must be paid during a bankruptcy reorganization, and arrearages are *nondischargeable*, which means that a domestic support creditor may continue to attempt to collect support regardless of any bankruptcy discharge that a debtor may receive.

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<sup>12</sup> 146 CONG. REC. S226-7 (statement of Sen. Schumer).

<sup>13</sup> H.R. 333 (S. 420), 107<sup>th</sup> Congress, 1<sup>st</sup> Sess. §328 (2001).

<sup>14</sup> The actual numerical rank of the priority (first, second, third, etc.) does not necessarily reflect its “importance.” In any given bankruptcy it is unlikely that there will be creditors in each category.

Many women's and consumer groups have criticized the legislation because of the adverse impact they believe it will have on debtors' ability to pay support. This criticism is not generally directed at the status of support payments *within* bankruptcy. To the extent that any creditor gets paid in bankruptcy, child support creditors are likely recipients. And, child support is nondischargeable. The concern is directed to competing claims for payment in two situations. First, if or when a debtor does *not* file, because he is ineligible for chapter 7 – and won't undertake or can't complete a reorganization plan. Second, when a debtor receives a bankruptcy discharge, there will be, under the reform legislation, many new classes of nondischargeable debt that may compete for payment along with family support (including money owed by the debtor to government agencies for support). Several of the new categories of nondischargeable debt are various types of credit card debt.

The legislation's supporters counter that child support payments are favored under federal and state law. There are federal and state programs to collect payment of child support.<sup>15</sup> But outside of a bankruptcy court, there is no single forum where an individual's debts are assembled and assigned priority of payment. Debt collection outside of bankruptcy is fact-specific and may depend on many variables, including an individual's intent with respect to debt repayment and the creditor's resources to pursue debt collection.

***Linking bankruptcy treatment of credit card debt to credit lending practices.*** Several provisions in the reform bills would significantly enhance the status of credit card lenders in a consumer bankruptcy. More categories of credit card debt would become nondischargeable and creditors in general would play a greater role in the bankruptcy. Although it is difficult to determine the precise relationship between increases in consumer credit and increased consumer bankruptcy filings,<sup>16</sup> many believe that there is a connection between aggressive credit marketing and bankruptcy filings.

To address the perceived "linkage" between credit marketing and failure of credit management, *i.e.* bankruptcy, many proponents and opponents of reform insisted upon measures to enhance consumer education about the consequences of credit card usage. Both the House and Senate versions in the 106<sup>th</sup> Congress had provisions requiring studies by the Board of Governors of the Federal Reserve and amendments to the Truth in Lending Act (TILA), 15 U.S.C. § 1637, requiring informational disclosures in connection with credit card advertising and billing statements. The House version mandated more studies, with fewer actual disclosure requirements. The Senate version had more disclosure requirements and fewer study requirements. The bill ultimately passed by both houses at the conclusion of the 106<sup>th</sup> Congress subsequently incorporated broader disclosure requirements by credit lenders through amendments to TILA. Although both the House and Senate bills before the 107<sup>th</sup> Congress incorporate the amendments to TILA mandating broader disclosure requirements, these provisions have traditionally found more support in the Senate than the House.

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<sup>15</sup> See CRS Report 97-408, *Child Support Enforcement: New Reforms and Potential Issues*, by Carmen Solomon-Fears.

<sup>16</sup> See CRS Report 98-277, *Bankruptcy and Credit Card Debt: Is There a Causal Relationship?* by Mark Jickling.