CRS Issue Statement on Bankruptcy in a Distressed Economy

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January 6, 2010
Article I, Section 8 of the Constitution gives Congress power to establish uniform laws on the subject of bankruptcy throughout the United States. Two of the major purposes of the bankruptcy code—to allow overwhelmed debtors to make a fresh start and to provide for equitable treatment of creditors—are in perpetual tension. At any given moment, either debtors or lenders are likely to feel that the law favors the other group. Thus, there is constant pressure to change the Bankruptcy Code. In 2005, Congress enacted significant and controversial changes in the code with the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA; P.L. 109-8). Although it included some changes involving business bankruptcies, BAPCPA has generally been viewed as having made bankruptcy less friendly to consumers. There was a surge in consumer filings just before the new law took effect in October 2005. After the new law took effect, the number of consumer filings dropped sharply, but they have risen steadily since.

In 2009, 1.41 million non-business bankruptcy filings were reported. This is an increase of more than 30% over 2008 filings and is not far behind the filings for 2004. It is the highest number reported since BAPCPA took effect. In 2009, total business bankruptcies also increased by more than 30% over 2008 filings, with a greater proportion of those filings being under chapter 11 reorganization. Although some attribute the increases to the effects of the distressed economy, others note that filings have increased by over 30% in each year after the 2006 post-BAPCPA drop. Whatever the cause of the increase in 2009, most expect filings to continue to increase in 2010.

In addition to monitoring the implementation and impact of BAPCPA, Congress may consider specific changes to the Bankruptcy Code. Proposals to allow modification of home mortgages have been introduced numerous times in both the 110th and 111th Congresses. The BAPCPA-created “means test” has also been the subject of proposed legislation that would waive application of the test to certain debtors, including some military personnel or those who have encountered financial difficulty as the result of medical expenses or income lost after a severe illness or injury. General application of the “means test” for consumer bankruptcies has generated some controversy both in the way in which monthly income is calculated and in the way in which allowable expenses are determined.

The bankruptcies of Chrysler and General Motors have brought attention to using asset sales as a means of reorganization. These sales, referred to as “363 sales” because they are authorized by 11 U.S.C. § 363, are viewed by some as becoming the norm for chapter 11 cases. Some believe that they result in less money for the creditors than would be available under chapter 7 liquidations. Also of concern is businesses’ use of bankruptcy to shift pension and other benefit obligations to the federal government and to shed unwanted contracts without the remedies that would be available outside of bankruptcy.

Consumers and businesses have not been alone in their economic distress—municipalities have also been affected. At least one—Vallejo, California—has entered bankruptcy through the provisions in chapter 9 and was allowed to reject collective bargaining agreements under the Bildisco three-part test rather than being required to follow the procedures established in chapter 11. Nearly 20 years ago, Congress considered incorporating § 1113, which addresses the procedure for rejecting collective bargaining agreements under chapter 11, into chapter 9, but no change was enacted. The Vallejo bankruptcy may rekindle interest in a similar proposal.

The outcome of bankruptcy cases currently before the U.S. Supreme Court may lead to other proposals for changing the Bankruptcy Code. These cases involve student loans, “disposable
monthly income,” property that may be exempted from the bankruptcy estate, and both prohibited and compelled speech.

Specific Policy Questions

Consumer

- Has BAPCPA had its intended effect of reducing abusive filings, or does it impose unreasonable burdens on consumers in financial distress through no fault of their own?
- Is the BAPCPA requirement that consumers complete a credit counseling course genuinely helpful, or is it simply a costly “checkoff” item for debtors in the process of filing bankruptcy?
- Is BAPCPA’s definition of a debtor’s “current monthly income” as the monthly average of the debtor’s income for six calendar months immediately preceding the month in which the bankruptcy petition was filed compatible with the twin goals of bankruptcy? Does it, on the one hand, act to the detriment of debtors who had barely been able to manage their debt load prior to experiencing significant drop in income, while, on the other hand, benefiting debtors who experience a temporary low income period?
- Should bankruptcy courts be allowed to apply the Internal Revenue Service’s Collections Standards tables differently to debtors in bankruptcy than the Internal Revenue Service applies those standards to delinquent taxpayers?
- Should bankruptcy courts be allowed to modify principal residence mortgages by reducing the amount owed to the market value of the home? Would this change enable a significant number of homeowners to avoid foreclosure? Would it have a significant impact on the overall mortgage market?
- Should residents of one state be able to fully exempt the value of the equity they have in principal residences from their bankruptcy estate while residents of another state are restricted in their ability to exempt that value?
- Should student loans remain generally nondischargable in bankruptcy? Should privately funded loans be treated differently in bankruptcy than government funded loans?

Business

- Is bankruptcy being used as a means through which solvent debtors may easily modify or eliminate contracts? Examples would include collective bargaining agreements, retiree benefits and pensions, and auto dealership franchise agreements.
- Should collective bargaining agreements enjoy specific protection only in chapter 11 bankruptcies or should they be protected in some or all other bankruptcies (for example, municipal bankruptcies under chapter 9)?
- Have the restrictions on key employee retention plans that were introduced by BAPCPA provided the anticipated limitations on employee compensation?
• Should limitations be placed on § 363 sales? In chapter 11, should they be available only pursuant to a confirmed plan of reorganization?

• Should there be special provisions (perhaps a separate chapter in title 11) for so-called “too big to fail” companies? Would it be preferable to model these provisions after the conservatorship/receivership provisions for banks?

General

• Are bankruptcy petition preparers subjected to an unreasonable risk of identity theft due to their being required to place their Social Security numbers on all documents prepared by them for submission to a U.S. bankruptcy court or U.S. district court in conjunction with a case file under title 11 U.S.C.? Should they instead be issued a unique identifying number to use on such documents?

• Did Congress intend “debt relief agencies” to include attorneys? If so, did it intend that the prohibition on advising incurring additional debt in contemplation of bankruptcy apply only to advice that would be fraudulent or be an abuse of the bankruptcy laws?

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