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ECONOMIC COMMENTARY

Recent Changes in the Consumer Bankruptcy Laws

by K. J. Kowalewski

In April 1981, the Subcommittee on Courts of the Senate Judiciary Committee began hearings to determine why there was such an extraordinary increase in personal bankruptcies since passage of the Bankruptcy Reform Act of 1978, and to determine appropriate corrective action. The subcommittee rather quickly concluded that the 1978 code, which became effective in October 1979, promoted an excessive number of personal bankruptcies and needed to be amended.

However, action was not taken by Congress, because the issue of amending the law became complicated by two Supreme Court rulings. One permitted a company that has filed for reorganization under Chapter 11 to reject its collective bargaining agreement with its workers, and the other declared the bankruptcy court system unconstitutional. Powerful and diverse political interests thus became involved, and agreements were not worked out until early 1984. The proposed changes were included in H.R. 5174 and, after minor amendments by the Senate, were passed by both Houses of Congress on June 29, 1984. The bill was signed by President Reagan on July 10, 1984, as the Bankruptcy Amendments and Federal Judgeship Act of 1984.

The following discusses the major changes to the consumer bankruptcy provisions embodied in the 1978 code, the apparent problems with these changes, and the latest corrections introduced by the 1984 amendments.

Bankruptcy Reform Act of 1978

The Bankruptcy Reform Act of 1978 was the first complete revision of the U.S. bankruptcy law since 1898. It was also the first major revision of the consumer bankruptcy provisions since the Chandler Act of 1938, which introduced the wage earner's or debt restructuring plan (Chapter 13).[1] Since the early 1900s, consumer debt and bankruptcies have grown tremendously. The old bankruptcy law and the existing bankruptcy court system could not cope with the greater complexity and growing number of consumer bankruptcy filings.

At least seven failings of the consumer provisions in the 1938 law were identified. First, the cost of filing a petition was high. Second, exempt assets (those which could be kept by the consumer after bankruptcy and not used to repay debts) were determined by state law and were usually minimal. Third, consumers could keep collateral only if they paid the value of the creditor's security interest, which usually was significantly greater than the collateral's market value. Fourth, there were restrictions on which debts could be discharged, that is, forgiven, and not paid by the consumer. Fifth, creditors usually were not prevented from trying to collect their debts after a bankruptcy petition was filed, or after bankruptcy "relief" was granted. Sixth, there were few restrictions on discrimination against former bankrupts by employers. Finally, Chapter 13 was defective in a number of ways. These failings were so great that only the most destitute consumers, those with low current incomes, few assets, and poor future income prospects, found bankruptcy a source of relief. Some analysts also felt that these failings increased the stigma associated with bankruptcy.[2]

To alleviate these problems, the new bankruptcy code was developed in 1978. Apart from redesigning the bankruptcy court system, the many changes introduced by the new code attempted to correct the above failings by defining the rights of creditors and debtors more specifically. The new code significantly altered the costs of bankruptcy. Among all the changes it introduced, four important ones with regard to consumer bankruptcy cases may be distinguished.[3] The first change limited the actions creditors can use to collect their debts both before and after a bankruptcy petition is filed. This change was intended to protect consumer debtors and their cosigners from abusive debt collection practices. It was also designed to help creditors by preventing some creditors from "rushing the gate" by collecting their debts directly from the consumer debtor just before or after a bankruptcy petition is filed, but before the bankruptcy process begins.

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1. There are two bankruptcy options for consumers: Chapter 7 and Chapter 13. In Chapter 7, all of a consumer's nonexempt assets are sold to repay debts. In Chapter 13, the bankruptcy court establishes a plan to allow a consumer to keep his nonexempt assets and repay his debts out of future income.

2. *Bankruptcy Reform Act of 1978*, Prepared Statement of Claude Rice, Alvin O. Wiese, Jr., and Jonathan M. Landers, Hearings Before the Subcommittee on Courts of the Committee on the Judiciary, U.S. Senate, 97 Cong., 1 Sess. April 3 and 6, 1981 (U.S. Government Printing Office), p. 54.

Before the 1978 code, these "gate-rushers" usually could keep the money they collected, leaving less of the consumer's assets to settle the claims of other creditors, even those who had the same legal rights to the consumer's assets as the "gate-rushers." Under the new code, the other creditors can make the "gate-rushers" return these funds to the consumer's estate for possible distribution to the other creditors.

A second change in the 1938 code essentially dropped all preconditions for a bankruptcy filing. Under the revised code, any consumer can file for bankruptcy, regardless of whether or not he can pay his debts out of current or future income. This was designed to protect consumers from overbearing debt collectors, and to protect creditors from themselves.

The third code change lowered the cost of bankruptcy by allowing consumers to keep more of their assets and future income after bankruptcy. This was done in four ways: (1) by creating federal exemption limits, which were typically more generous than the state limits, (2) by allowing consumers to discharge a greater variety of debts, and (3) by allowing debtors to redeem consumer goods by paying secured creditors the lesser of the market value of the collateral, or the creditors' security interest, as full payment of their debts. These provisions were created to give the honest consumer more help in starting a new life after bankruptcy.[4]

Finally, the 1978 code attempted to make Chapter 13 relatively more attractive to financially distressed consumers than Chapter 7, without increasing losses to them. It protected creditors by requiring that a Chapter 13 plan leave them at least as well off as they would be in a Chapter 7 filing. It made Chapter 13 more attractive by permitting the redemption of any collateral, giving greater protection to co-debtors, requiring only secured creditor approval of a Chapter 13 plan, and widening the class of dischargeable debts. A final and controversial requirement was that the plan be filed "in good faith," as determined by the bankruptcy judge; minimum payments or repayment periods were not required.

Effects of the New Code

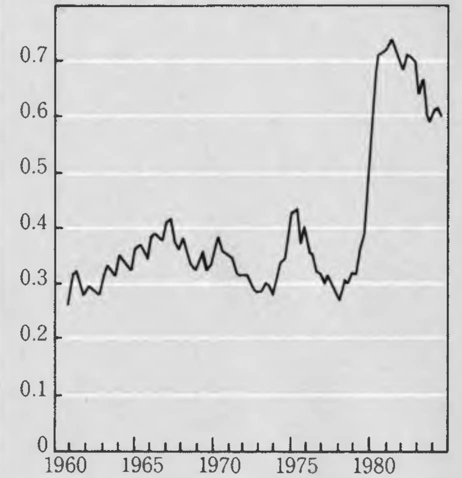
After the new code became effective in October 1979, personal bankruptcy filings rose sharply (see chart). From 57,841 (about 38 per 100,000 persons aged 20 years and above) in the third quarter of 1979, personal bankruptcy filings in the United States rose to an all-time high of 116,880 (about 74 per 100,000 persons aged 20 years and above) in the second quarter of 1981.[5] Personal filings have fallen to 100,332 (about 60 per 100,000 persons aged 20 years and above) in the third quarter of 1984, but they are still above their third quarter 1979 level, and over one and one-half times their pre-1979 peak in second quarter 1975.

This increase in personal filings coincided with a sharp rise in loan losses for consumer lenders. For example, the National Retail Merchants Association reported that the increase in loan losses due to bankruptcy at most of the large department store chains varied between 90 percent and over 200 percent between 1979 and 1980.[6]

It should not be surprising that there was an increase in personal bankruptcy filings after third quarter 1979, because the economy was entering a three-year recession—a period of high interest rates and zero output growth. Personal and business bankruptcies usually increase in recessions. However, a number of studies of nationwide personal bankruptcy filings have concluded, after allowing for the effects of the business cycle, that the new bankruptcy code was also partially responsible for this extraordinary increase in personal filings.[7]

Studies of individual personal bankrupts also suggested that the 1978 code was responsible for the increase in personal filings. A study conducted by the Credit Research Center for the Coalition for Bankruptcy Reform (a group of consumer credit and associated organizations) found that between 30 percent and 40 percent of the debtors in their sample could repay at least one-half of their debts within five years.[8] This study, and those by the General Accounting Office and by Brimmer and Co., Inc., found that the main differences between consumers who filed under the 1938 law and those who filed under the new 1978 code were that the latter consumers had greater amounts of assets, debts,

Chart 1 Personal Bankruptcy Filings
Filings per thousand people over 20 years of age



SOURCES: Administrative Office of the U.S. Courts. Washington, DC; and U.S. Bureau of the Census.

and incomes. The reasons for filing and the demographic characteristics of the consumer bankrupts were not much different in the two groups.[9] Thus, it appeared that the new code was encouraging unnecessary bankruptcy filings by more affluent consumers.

Moreover, casual evidence submitted in Congressional testimony showed that the percentage of unsecured debts agreed to be repaid in Chapter 13 plans varied considerably

3. For further details, see K.J. Kowalewski, "Consumer Lending and the Bankruptcy Reform Act of 1978," *Economic Commentary*, Federal Reserve Bank of Cleveland, January 12, 1981.

4. Increasing the value of exempt assets may be viewed as an attempt to correct the effects of past inflation, which eroded the real value of the exemption limits.

5. These figures are not seasonally adjusted quarterly rates.

6. *Bankruptcy Reform Act of 1978*, Prepared Statement of Richard E. Kerr, *Hearings*, p. 163.

7. See K.J. Kowalewski, "Personal Bankruptcy: Theory and Evidence," *Economic Review*, Federal Reserve Bank of Cleveland, Spring 1982, and the references cited therein.

8. See *Consumers' Right to Bankruptcy: Origins and Effects*, Monograph No. 23, Consumer Bankruptcy Study, Volume 1, West Lafayette, Indiana:

across the nation. In some circuit court districts, the fraction was generally greater than 50 percent, while in other districts the norm was closer to zero. A number of representatives from the consumer credit industry argued that the lack of eligibility requirements for bankruptcy and the lack of specific guidelines for debt repayments in Chapter 13 allowed unscrupulous consumers to avoid paying at least some of their debts while keeping all of their property. In addition, they contended that the law gave other consumers the impression that bankruptcy was not a serious matter, but an acceptable way to reduce onerous debt burdens without serious repercussions.

Amendments to the New Code

This evidence, plus expert testimony by lawyers, bankruptcy judges, and members of the consumer credit industry persuaded Congress to tighten the consumer provisions of the 1978 code. These changes are found in the Bankruptcy Amendments and Federal Judgeship Act of 1984; their intent is to curtail alleged abuses of the spirit of the law, and to increase the cost of bankruptcy.[10]

Most of the changes made in 1984 attempt to limit the possibility of abuse by consumers. The most important change gives the court the power to dismiss a Chapter 7 consumer case "if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. However, there shall remain the presumption in favor of granting the relief requested by the debtor."[11] Presumably, the judge will permit the consumer to file a Chapter 13 petition in this case.

Another anti-abuse change excludes two types of debts from discharge. One is a debt of $500 or more for "luxury goods or services" incurred no earlier than 40 days before the bankruptcy petition is filed. The other exclusion is for certain cash advances totaling more than $1,000, incurred no earlier than 20 days before the petition is filed. These debts were singled out, because consumer credit lenders testified before Congress that some consumers were buying goods with credit in anticipation of filing for bankruptcy, knowing that they would be able to keep the goods without paying for them.

Two sets of anti-abuse changes speed up the adjudication process and minimize confusion and the opportunity for successful delaying tactics by consumers. In the first change, the consumer's obligations are expanded to include: (a) submitting a schedule of current income and expenditures, (b) submitting within 30 days of filing for a Chapter 7 bankruptcy a statement describing the debtor's intentions (surrender, redemption, exemption, reaffirmation, or retention) with respect to all property pledged as collateral for outstanding debts, and (c) executing such intentions within 45 days after submitting the latter statement.

In the second change, the consumer must begin payments proposed by a Chapter 13 plan within 30 days after the plan is filed. The trustee retains the payments until the plan is confirmed (in which case he distributes the accumulated payments to the creditors), or denied (in which case he gives the funds back to the consumer minus any eligible administrative expenses), and must ensure that the consumer begins making timely payments. If the debtor willfully fails to do so, the court may convert the case to a Chapter 7 case, or dismiss the case entirely, denying the consumer relief from bankruptcy. In the latter event, the consumer cannot refile for bankruptcy relief for 180 days.

The most important modification of Chapter 13 is designed to curtail abuse, and to increase the cost of bankruptcy. It requires that a Chapter 13 plan either essentially pay *all* unsecured claims in full or provide that *all* of the consumer's projected disposable income (that is, income in excess of reasonably necessary living and business-related expenses) during the three-year period beginning on the date that the first payment is due under the plan is used for debt repayments.[12] Four other changes introduced in 1984 explicitly alter the cost of bankruptcy to consumers.[13] First, consumers using the federal exemption limits are now restricted to $4,000 in all household furnishings and goods, clothing, appliances, books, animals, crops, or musical instruments that are held primarily for the personal, family, or household use of the consumer or a dependent of the consumer, with the same maximum of $200 per item. Previously, the total dollar amount of exemptions in these goods was unlimited. In combination with the $200 per item limit, this allowed consumers to exempt most of their assets.

Second, debtors using the federal exemption limits are restricted to $400 plus $3,750 (instead of the previous $7,500) of any unused portion of the $7,500 principal residence provision to exempt any property.

Third, each individual in a joint bankruptcy filing is allowed to claim separate sets of exempt assets, but unless the federal limits are overridden by state law, both individuals must now use the same exemption limits.

Fourth, a significant change is made with regard to certain debt repayments made before a bankruptcy filing.[14] The trustee cannot make a creditor return the payment or transfer if "the aggregate value of all property that constitutes, or is affected by such transfer, is less than $600." Hence, regardless of any other factors, a creditor can keep the transfer as long as it is less than $600.

Credit Research Center, Krannert Graduate School of Management, Purdue University, 1982; and *Personal Bankruptcy: Causes, Costs, and Benefits*, Monograph No. 24: Consumer Bankruptcy Study, Volume II, West Lafayette, Indiana: Credit Research Center, Krannert Graduate School of Management, Purdue University, 1982.

9. *Bankruptcy Reform Act of 1978—A Before and After Look*, Report by the Comptroller General of the United States to the Chairman, Committee on the Judiciary, U.S. House of Representatives, U.S. General Accounting Office, July 20, 1983; and *Bankruptcy Reform Act of 1978*, Prepared Statement of Andrew F. Brimmer, *Hearings*, pp. 13–38.

10. Not all of the changes favor creditors. There are two minor changes that protect debtors. One allows an individual to recover costs and attorney fees and punitive damages in certain circumstances; the other prevents a private employer from firing or discriminating against an individual solely because that individual once was

Finally, three minor changes in the 1978 law are designed to clarify the consumer's options in bankruptcy. The first requires that the consumer be told which chapters of the bankruptcy code he is eligible to use. Presumably, once informed of his choices, the consumer may choose whatever best serves his interests. The second change gives the debtor an extra 30 days (60 days in total) to rescind discharge agreements. The third change makes explicitly clear that even though a debt may be dischargeable, the consumer may voluntarily repay the debt. This condition clarifies any ambiguity about a consumer's set of possible actions. Curiously, it does not specify that the consumer actually be told about this option.

Likely Impact of the Amendments

On the surface, the changes adopted in 1984 appear to be serious and substantial. The costs of bankruptcy are raised, attempts are made to curtail abuses by consumers, and an impression is indirectly given that bankruptcy is a serious matter. Indeed, consumer creditors are pleased with the changes, and say that because they are better protected, they will be less reluctant to lend to lower-income consumers.

However, it is likely that the success of these changes in lowering either the total number of personal bankruptcy filings, or in lowering creditor loan losses, will be minor unless the bankruptcy judges strictly enforce the main anti-abuse provision and obtain the cooperation of state courts. There are several reasons for this. First, there are no solid statistical data on the number of consumer abusers, or on the dollar loss they represent. The amendments were designed with only anecdotal evidence of abuse provided by consumer lenders. If abuse is truly minor, then the preference and discharge provisions will have only marginal effects.

Second, the 1978 code allowed states to prevent their consumer residents from using the relatively more generous federal exemption limits. By September 1982, 33 states substituted their own less generous exemption limits. The lower federal exemption limits thus already are inoperable in these states. They also may have little impact in the other 17 states and in the District of Columbia. Two studies comparing the number of bankruptcy filings in states that opted out of the federal exemptions with those in the other states found that lower exemption limits had a minor impact on personal bankruptcy filings.[15]

Finally, the changes unquestionably raise the cost of a Chapter 13 filing, thus giving consumers the incentive to use Chapter 7. The bankruptcy court can dismiss a Chapter 7 case if it feels that the case would be an abuse of the law. However, in certain circumstances, the amendments let any party demand that the case be referred to a state court, which has the power, without appeal, to overrule the bankruptcy court. Thus, consumers may be able to obtain a more favorable settlement. If this loophole becomes a problem, creditors may seek to amend the bankruptcy code further.

granted bankruptcy relief at some time, was insolvent, or did not pay a dischargeable debt.

11. Section 312, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L, No 98-353, 98 Stat. 333, July 10, 1984.

12. Other changes give creditors additional leverage in collecting cosigned debts and allow certain unsecured creditors to request a modification of the plan at any time after confirmation, but before completion of the plan.

13. Recall that new discharge provisions also raise the cost of bankruptcy to some consumers.

14. These payments are known as preferences, which are transfers of any property interest of a consumer to a creditor or for the creditor's benefit that is made within 90 days before the filing while the consumer was insolvent, and that enables the creditor to receive more than he would have received in a liquidation case without the transfer.

15. *Bankruptcy Reform Act of 1978—A Before and After Look*; and Lawrence Shepard, "Personal Failures and the Bankruptcy Reform Act of 1978," *Journal of Law and Economics*, vol. 27 (October 1984), pp. 419-27.

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