

ALI-ABA

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Summary of Certain Critical Consumer and Exemption Provisions

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I. Introduction

In 1934, the Supreme Court wrote that “[o]ne of the primary purposes of the Bankruptcy Act is to relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.”¹ Since this depression-era decision, bankruptcy filings surged past 1.4 million by 1998 despite a robust economy that experienced the lowest unemployment in three decades.² Similarly, during the boon of the 1990s, the annual rate of bankruptcy filings grew exponentially to more than double the number that had occurred during the entire decade of the Great Depression.³ There is good news: despite what may seem like the development of a new social class of debtors, bankruptcy filings actually fell 3.9% to 1.55 million last year – the first such decline since 2000.⁴

It remains to be seen whether this trend will hold steady through the first half of 2005, but recent reforms may skew the results in either direction. On April 20, 2005, President Bush signed a sweeping piece of legislation that could turn bankruptcy on its head. Titled the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005⁵ (“BAPCPA” or the “Reform Act”), it aims to curb the amount of consumer filings, given that personal bankruptcies outpace business

¹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

² See Joe Pomykala, Ph. D., *Bankruptcy Laws: The Need for Reform*, USA Today Magazine, Vol. 128, No. 2654, pp. 20-23 (Nov. 1999).

³ *Id.*

⁴ Bankruptcy filings in the federal courts dropped nearly 4 percent in calendar year 2004, according to data released by the Administrative Office of the U.S. Courts. Total bankruptcies filed in the twelve-month period ending December 31, 2004, totaled 1,597,462, down 3.8 percent from the 1,660,245 petitions filed in the 12-month period ending December 31, 2003. Despite the decline for 2004, total filings still exceed the 1.5 million bankruptcies first reported in 2002. Information available at <http://www.bankruptcy-courts.net/bankruptcy-filings.html>.

⁵ S.256, 109th Cong., 1st Sess. (2005).

filings by more than 45 to 1.⁶ Although a small number of the provisions take immediate effect, including limitations on the homestead exemption, most of the new provisions become law on October 17, 2005. Consequently, bankruptcy lawyers are bracing for what could be a significant swell in filings in advance of the new law.⁷ Although there may be an initial spike in bankruptcy filings in anticipation of the October effective date, the Reform Act's chief objective is to reduce the number of filings and increase debtor responsibility and repayment.

With respect to the interests of creditors, the Reform Act's provisions "respond to many of the factors contributing to the increase in consumer bankruptcy filings, such as lack of personal financial accountability, the proliferation of serial filings, and the absence of effective oversight to eliminate abuse in the system."⁸ In recent years, Congress has attempted to reform the Bankruptcy Code eight times; a move broadly supported by the business community, banking and financial services industries as well as family farmers and child support enforcement agencies.⁹ Where former attempts failed, the Reform Act garnered enough support; the impetus being that "abuse of the system is more widespread than many would have estimated."¹⁰

BACPA attempts to strike a balance between mandating repayment and keeping the inherent "fresh start" of bankruptcy. Only time will tell if the amendments emphasize a "public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt."¹¹ The Reform Act maintains that it is a comprehensive package of reform measures, aimed at "improve[ing] bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors."¹²

⁶ *Id.* For the calendar year 2004, personal bankruptcies totaled 1,563,145, while business filings amounted to 34,317.

⁷ Colleen Debase, *Bankruptcy Bill May Spur More Chapter 11 Filings*, Wall St. J., Mar. 15, 2005, at D2.

⁸ See H.R. REP. 109-31(I), at 2, 109th Cong., 1st Sess. (2005).

⁹ *Id.* Comprehensive bankruptcy reform legislation (H.R. 2500, the "Responsible Borrower Protection Bankruptcy Act") was first formally introduced in the House on September 18, 1997. H.R. 2500, 105th Cong. (1997).

In June, 1998, the U.S. House of Representatives passed what would have been the largest overhaul to the Bankruptcy Code in twenty years. A parallel but slightly more flexible bill was passed by the Senate in September, 1998. The Senate and House versions were then reconciled just before Congress adjourned in October, 1998. The House approved the reconciled legislation, but the Senate bypassed a vote on the final bill. The bill was not resuscitated. Similar legislation was introduced in 1999, which again failed to pass through Congress.

Similar reform legislation was passed by Congress at the close of the 2000 session, but President Clinton vetoed the bankruptcy reform legislation on December 19, 2000, well into Congress' winter recess, and too late for an override. President Clinton criticized the bill as being unfair to ordinary debtors and working families experiencing hard times.

Finally, 2001 saw another reincarnation of the reform legislation. A conference committee meeting was scheduled for September 12, 2001, but never took place because of 9/11. The House and Senate Bills were finally reconciled in 2002, but stalled on a political hot-button issue when language to bar the discharge of debts arising from abortion clinic protests was added.

¹⁰ *Id.* (citing Christopher Marshall, *Civil Enforcement: An Early Report*, Journal of the Nat'l Ass'n of Bankr. Trustees (NABTalk) 39 (Fall 2002).)

¹¹ *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

¹² See H.R. REP. 109-31(I), at 2, 109th Cong., 1st Sess. (2005).

II. Credit Counseling and Debtor Education

In their current form, consumer credit counseling agencies assist consumers who have problems managing their debts by: counseling the consumer about managing a household budget, creating a debt management plan (a “DMP”) plan for the payment of the consumer’s credit card debt; negotiating between the consumer and his creditors; and disbursing a consumer’s collective payment among the participating creditors.¹³ Compensation to these agencies is accomplished primarily through two vehicles. First, the creditor that receives payments pursuant to the agency’s DMP may pay a percentage of the received funds to the counseling agency based on the amount of funds it has received. Second, the consumer who receives the services may pay for them.¹⁴ The stated goal of these programs is to keep the consumer out of bankruptcy by creating a manageable payment system. Congress has taken this framework and institutionalized it in the Reform Act.

Mandatory Credit Counseling. Before an individual files for bankruptcy under either Chapters 7 or 13, BAPCPA mandates debtors considering bankruptcy receive credit counseling within the six months before filing for bankruptcy. The law further requires that they receive additional counseling before the case is finalized.¹⁵ In pertinent part, the new 11 U.S.C. § 109(h)(2) declares that “an individual may not be a debtor under this title unless such individual has, during the 180-day period preceding the date of filing the petition by such individual, received from an approved nonprofit budget and credit counseling agency...an individual or group briefing (including a briefing conducted by telephone or on the Internet) that outlined the opportunities for available credit counseling and assisted such individual in performing a related budget analysis.” Before passing the Reform Act, the House explained this burden is “intended to give consumers in financial distress an opportunity to learn about the consequences of bankruptcy – such as the potentially devastating effect it can have on their credit rating – before they decide to file for bankruptcy relief.”¹⁶

Exceptions. A debtor may be temporarily excused from this requirement if he or she submits to the court a certification that: (1) describes exigent circumstances which merit waiver; (2) states that the debtor requested credit counseling services from an approved nonprofit budget and credit counseling agency, but was unable to obtain such services within the five-day period (prescribed by the statute) beginning on the date the debtor made the request; and (3) satisfies the court.¹⁷ This exception is not indefinite; the debtor must still meet the requirements for credit counseling participation within 30 days after the case is filed, unless the court, for cause, extends this period up to an additional 15 days.¹⁸

In addition, the mandatory credit counseling requirement does not apply to a debtor whom the court determines, after notice and a hearing, is unable to complete this requirement

¹³ Michael Greenfield, *Memorandum to the Consumer Debt Counseling Drafting Committee*, (June 3, 2005) at <http://www.law.upenn.edu/bll/ulc/UCDC/oct2003memo.doc>

¹⁴ *Id.*

¹⁵ S.256, § 106(a).

¹⁶ H.R. REP. 109-31(I), at 18, 109th Cong., 1st Sess. (2005).

¹⁷ New 11 U.S.C. § 109(h)(3)(A), as amended by proposed Reform Act §§ 106(a) ; 802(d); 1007(b); 1204(1).

¹⁸ New 11 U.S.C. § 109(h)(3)(B), as amended by proposed Reform Act §§ 106(a) ; 802(d); 1007(b); 1204(1).

because of incapacity, disability, or active military duty in a military combat zone.¹⁹ Incapacity, under this provision, means the debtor is impaired by reason of mental illness or mental deficiency so that the debtor is incapable of realizing and making rational decisions with respect to his or her financial responsibilities.²⁰ Disability, under this provision, means the debtor is so physically impaired as to be unable, after reasonable effort, to receive credit counseling whether by participating in person, or via telephone or Internet briefing.²¹

Commentary. A debtor now encounters a significant roadblock to entering bankruptcy protection. Not only must the debtor obtain counseling in advance, but also the insolvent debtor, if marginally able, must foot the bill because the Reform Act provides no funding for these services. Moreover some courts question to effectiveness of credit counseling.²² While credit counseling has a benign ring, Senate hearings with regard to the industry have led Senator Norm Coleman to describe the credit counseling industry as a network of not for profit companies linked to for-profit conglomerates.²³ Critics point to an industry plagued with “consumer complaints about excessive fees, pressure tactics, nonexistent counseling and education, promised results that never come about, ruined credit ratings, poor service, in many cases being left in worse debt than before they initiated their debt management plan.”²⁴ The detractors of the new measure argue that compulsory credit counseling would place susceptible debtors at the mercy of an industry where, according to a recent congressional investigation, many of the counselors and creditors are seeking to profit from the misfortune of their customers.²⁵

The above concern raised in the Senate investigation may have resulted from the AmeriDebt bankruptcy. On June 5, 2004, AmeriDebt, Inc., formerly one of the nation’s largest

¹⁹ New 11 U.S.C. § 109(h)(4), as amended by proposed Reform Act §§ 106(a) ; 802(d); 1007(b); 1204(1).

²⁰ *Id.*

²¹ *Id.*

²² *In re Fitzgerald* 155 B.R. 711, 716 n.5 (Bankr. W.D. Tex. 1993): “The programs are hardly perfect, of course. Without an automatic stay, they depend on creditor consent, so that just one noncooperative creditor can undermine their effectiveness.”

²³ See generally S. REP. 109-55 (2005): *Profiteering In A Non-Profit Industry: Abusive Practices In Credit Counseling*.

²⁴ Letter to Senators Arlen Specter and Patrick Leahy: “Law Professors Against Bankruptcy Bill” (Feb. 16, 2005) at <http://www.billsbills.com/profsvbk.html>.

²⁵ See S. REP. 109-55 (2005): *Profiteering In A Non-Profit Industry: Abusive Practices In Credit Counseling*. Indeed, during the Senate investigation, two former “counselors” of AmeriDebt and Cambridge Credit Counseling testified as to the sales tactics they were instructed to practice in order to convince debt-ridden consumers to sign onto popular debt management plans (“DMPs”) rather than offering financial instruction or counseling. Under a DMP, a consumer would authorize the credit counselor to contact each of the consumer's unsecured creditors, which generally consisted of credit card companies. The counselor would then negotiate with each creditor to lower the consumer's monthly payments and the interest rate, and to waive any outstanding penalties. The consumer’s reduced monthly payments were then consolidated into a single payment, with the consumer sending a single payment to the credit counseling agency (“CCA”). The CCA would then distribute payments to each of the consumer's creditors.

The Senate hearings further revealed that DMPs were prevalent because all interest parties--the consumer, the creditor, and the CCA--received a “tangible benefit”: Consumers took control of their finances and received concessions from their creditors. Creditors received all of the principal debt owed by the consumer, rather than receiving pennies on the dollar if the consumer entered bankruptcy. Finally, the CCA, in return for coordinating the DMP, would receive “fair share” payments from the creditor, which covered the associated expenses, salaries, and operational costs. The CCA’s fair share allowance generally amounted to 12-15% of the payments received by the creditor under the DMP. Thus, a non-profit yields a significant profit.