Bankruptcy: Three Years After the Bankruptcy Reform Act of 2005

by Helen Mirza

Background

On October 17, 2005, a major U.S. federal bankruptcy reform law took effect. This change (the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, a.k.a. the Bankruptcy Reform Act of 2005) had been over 10 years in the making and represented the culmination of years of effort on the part of both consumer advocates and lenders, as well as regulators and others. This act amended the 1978 bankruptcy code, and was the most significant and sweeping change since that date. We summarized this seminal change in bankruptcy, focusing on nonbusiness filing ramifications, in the April 2006 edition of *Profitwise News and Views* (*PNV*). Also summarized were opinions of what the new law would mean for both consumers and creditors. The following article is a brief overview of trends in filings, and views regarding what has transpired in the interim. The article addresses the following questions:

- Has the new law met expectations?
- Has the new law made it easier or harder to obtain Chapter 7 discharge?
- Have certain practices previously deemed abusive been alleviated?

What the Filing Numbers Tell Us

In the eight-year period, 2000 through 2008, total nonbusiness bankruptcy filings increased every year with the exception of a modest decline (4 percent) from 2003 to 2004, and a huge decline of over 70 percent from 2005 to 2006.[1] After the signing by the president of the Bankruptcy Reform Act of 2005 (Reform Act) in April of that year, there was concern that the new law would make it more difficult to file and provide less protection than the old law. As a consequence, there was a 30 percent increase in filings in 2005 over the prior year, mostly from late spring through the summer and early fall of 2005, with most filers attempting to beat the October deadline when the new law was to take effect. Some in the legal community predicted a rush of filings prior to the date the new law took effect. In the prior article on bankruptcy in the April 2006 edition of *PNV*, we pointed out that, "Thousands of debtors rushed into court hoping to get their case filed before the law changed. During the final two weeks before the new law took effect, over 600,000 debtors filed for bankruptcy protection, compared with approximately 30,000 filings per week on average previously, and only 3,600 per week immediately following the effective date of the new law."[2] The

Table 1: Seventh District Nonbusiness Filings 2000–2008[3]

	2000	2001	2002	2003	2004	2005	2006	2007	2008*	9 Year Total
Illinois	59,892	73,036	81,091	84,520	79,320	105,964	29,774	40,416	54,049	608,062
Indiana	37,126	47,462	52,859	55,155	53,941	78,201	21,858	30,514	38,597	415,713
Iowa	8,079	10,787	11,454	12,259	12,722	18,254	4,683	6,793	7,730	92,761
Michigan	35,835	46,138	54,805	62,070	63,531	88,402	32,746	44,996	53,353	481,876
Wisconsin	17,164	21,347	24,439	27,524	24,439	37,420	11,010	15,439	20,994	199,776
District Total Per Year	158,096	198,770	224,648	241,528	233,953	328,241	100,071	138,158	174,723*	1,798,188

NOTE:*3 Quarters Average X 4 **SOURCE:** American Bankruptcy Institute.

increase in 2005 of total nonbusiness filers over 2004 was 31 percent (from 1,560,339 to 2,039,214).[4]

In 2006, filings fell to a 15-year low of 597,965 – a 71 percent decline over 2005.[5] Shortly after the October 2005 effective date of the new law, and possibly due to the dramatic decrease in filings and related fees, many attorneys began advertising campaigns to alert consumers that the 2005 change in the law did not preclude filing for bankruptcy, nor for the vast majority of individuals did it change practical outcomes with respect to what debts are discharged and what personal and real property filers may keep. The filings for 2007 increased by 38 percent over 2006, and the first three quarters of 2008 (data are not yet available for the fourth quarter) suggest a 32 percent increase in filings over 2007.[6]

In the District

The Seventh Federal Reserve District (Illinois, Indiana, Iowa, Michigan, and Wisconsin) experienced similar fluctuations in filing rates.

The changes in the Seventh District largely reflect national trends.

Review of Major Changes in the 2005 Legislation

Essentially, the 2005 reforms created a “means test” in order to file for Chapter 7 relief in which all nonpriority debt is discharged. The new law forces individuals with sufficient income (based on a formula) to file for Chapter 13 relief as opposed to Chapter 7, so that a filer with sufficient income would have to repay some, if not all, of his debt. Debt under Chapter 13 can be reduced or restructured with possible relief from penalties, interest, and other adverse consequences of untimely payment.

Other changes include required prefiling counseling in order to determine whether an individual is eligible for Chapter 7. Filers must also fully disclose all assets and debts, and complete an approved financial management course in order to obtain the final discharge, whether in Chapter 7 or 13.

State homestead exemptions (the ability to retain an equity interest in real property used as a principal residence) were also revised under the Reform Act. Under the revisions, debtors must have lived for two years in a given state before being able to take advantage of that state’s homestead exemption. Some states had extremely lenient exemptions, which may have encouraged individuals anticipating filing bankruptcy to transfer large portions of their wealth into homes in states where the exemption was high or virtually unlimited, thereby sheltering from creditors’ assets that would otherwise have to be liquidated to satisfy debt. Further, under the new law, property acquired less than 3.3 years prior to the bankruptcy filing is limited to $125,000 in homestead exemption regardless of the state’s exemption limit.

One of the major changes sought and incorporated in the new law by lenders was to eliminate the so-called “cram down” provisions of the prior law. This means that secured lenders with collateral other than real estate (mainly automobiles) had to settle for collateral value at the time of filing and were not entitled to “deficiency judgments.” Deficiency judgments represent an amount owed to lenders after subtracting the monies obtained from sale of collateral. In bankruptcy, the judge could declare that the total debt was extinguished by the current market value of the collateral at the time of filing (or the value realized at a later sale). This practice was considered an “abuse” of the system by many lenders, who claimed it was impossible to fully assess the risk of lending on personalty as collateral in the event of bankruptcy or to value it accurately.

The Bankruptcy Horizon

The current economic crisis has negatively impacted the financial health of individuals and families in the United States. As more and more industries and businesses seek government assistance to keep their businesses afloat, many employers, large and small, appear to be in jeopardy, creating the potential for higher levels of unemployment.

Table 2: Chapter 7 and 13 Nonbusiness Filings by Year

	Total* Filings	Chapter 7	Chapter 13	Chapter 13 Filings as % of Total
2002	1,537,730	1,086,459	450,217	29%
2003	1,624,677	1,155,081	467,908	29%
2004	1,562,621	1,117,304	444,352	28%
2005	2,039,214	1,631,011	407,322	20%
2006	597,965	349,012	248,430	42%
2007	822,590	500,613	321,359	39%
2008**	1,046,548	693,497	351,674	34%

NOTES: *Includes Chapter 11 de minimus filings – therefore, Chapter 7 and 13 do not foot exactly to total. **2008 totals annualized for fourth quarter data unavailable.
SOURCE: American Bankrupcy Institute.

Individuals and families with high debt levels may ultimately find it difficult, if not impossible, to avoid bankruptcy. The discharge of debt will further exacerbate lender losses. Pressure will also be put on state budgets for food stamps, child care, and other state funded programs as more and more individuals and families experience unemployment and erode financial resources.

Debtors in the past were often stigmatized by bankruptcy, and it was difficult to obtain credit for a considerable period of time after the discharge. However, in recent years, there has been an increasing willingness on the part of many lenders to extend credit to recent bankrupts. As a result, some people emerging from bankruptcy have been able to obtain credit and rebuild their credit worthiness and credit scores—some have not. This willingness to extend credit, however, may undergo a change if many bankrupts are unable to find and keep jobs. Katherine Porter, associate professor at the University of Iowa College of Law, testifying before the U.S. House Subcommittee on Financial Institutions and Consumer Credit in March 2008 stated that, "In my research, I found that in the first year after filing Chapter 7 bankruptcy, 96 percent of debtors received credit card offers."[7]

The 2005 bankruptcy changes did meet certain expectations. The perceived abuse of extremely high state homestead exemptions has been curbed. Furthermore, the vast majority of individuals filing for bankruptcy have been able to meet the income formula test (based upon being above the median state income level—individuals with incomes under that median do not have to meet the test under the formula and can proceed to file directly under Chapter 7).

Bankruptcy Reform's Role in the Foreclosure Crisis

Recently, news sources have begun to report on a new trend, where people have despaired of saving their home and make credit card debt a priority in order to maintain a source of cash flow and purchase power. One media report suggested that the 2005 Bankruptcy Reform Act, "…was a major reason for the foreclosure crisis and the falling housing prices that have affected virtually every home owner in the country."[8]

The data in Table 2, excerpted from the American Bankruptcy Institute Web site[9], show the breakdown of bankruptcy filings in the years leading up to and since the reforms of 2005.

A big increase in Chapter 7 and (somewhat less) significant decrease in Chapter 13 filings occurred in 2005 (date of Reform Act). Since 2005, both Chapters 7 and 13 filings have trended upward sharply, but the proportion of 13 filings, after a (predictably) sharp proportionate increase in 2006, has trended back down toward pre-2005 levels. Since no data are available regarding the number of Chapter 7 filers that were forced into Chapter 13 via the means test or otherwise, nor is the breakdown home owners versus renters among filers, it is difficult to infer any effect on foreclosure rates as a result of the 2005 reforms, since both chapters require repayment of secured debt (in Chapter 7 only if the filer wishes to take advantage of his homestead exemption). Accordingly, even if a significant portion of Chapter 13 filers were the result of failing the means test, the impact of reform on foreclosure filings remains an open question.

Congress has asked the National Bankruptcy Research Center to research and respond to a series of related questions submitted to it recently.[10] Once these questions have been answered and data gathered and published, it may be possible to determine with more certainty the role the Reform Act has had on the foreclosure crisis.

Conclusion

Many economists and researchers predict a continued rise in bankruptcy filings due to economic conditions. Our bankruptcy laws were imported and refined from similar laws in England prior to our nation's independence. The British system had revealed the trauma and limited effectiveness of prison and punishment for unpaid debt. In both Britain and the U.S., a more enlightened approach has been to allow those who simply cannot pay their accumulated debt to find a legal and safe means by which to begin anew financially. Safeguards are built into our system of bankruptcy (including how often one

A Practitioner's Viewpoint

Attorney Catherine Molnar-Boncela, from the law firm of Goveia and Associates of Merrillville, Indiana, has practiced bankruptcy law for over 20 years. The firm itself has specialized almost exclusively in bankruptcy for over 30 years. Ms. Molnar-Boncela stated that, *"In my experience and practice, the use of the means test has not had a material effect on the recommendation of a chapter 13 over a chapter 7 filing. The chapter choice process was already built in, to some degree, in the prior bankruptcy code in Section 707B, in that the attorney was expected to ascertain which chapter was appropriate for an applicant before filing and not just make a filing based on the applicant's preference."*

Since the formula for determining "means" considers actual income and expenses to reach a net capacity to repay, *"…a major and perhaps unintended consequence in its application is that the applicant with income that exceeds the state median income must also include the effect of any larger mortgage and car payments on disposable income. These higher income filers, as a result, then usually have limited disposable income to contribute to a chapter 13 plan and to unsecured creditors. Therefore, many higher income applicants nevertheless qualify for Chapter 7 as a result of higher expenses."* Many observers assumed that the means test would force the majority of higher income filers into Chapter 13, but given the nature of the means test, the effect of higher income is tempered when the filer also has extensive debt obligations and high payments.

From a different standpoint, Ms. Molnar-Boncela also observed, *"The vast majority of individuals seeking to file a bankruptcy petition that I have represented exhaust their exempt assets to pay secured and unsecured debt before they come to me. These exempt assets often include the equity in their homes, IRA, and 401(k) accounts. They do everything they can in an attempt to avoid financial ruin."*

Molnar-Boncela takes a very practical approach to helping those facing bankruptcy: *"I do my best to influence my clients to refrain from filing a bankruptcy petition while they have no income from a job or pension. A bankruptcy petition provides relief only when my clients have something to protect from garnishment or exemptions. As one of the bankruptcy judges I worked for liked to remind attorneys, 'A discharge is a terrible thing to waste.' A bankruptcy petition that is filed before a client returns to work will, of necessity, exclude subsequent medical bills and other dischargeable debt resulting from the period of unemployment."*

can file) to protect also the interests of creditors from irresponsible debt management. The bankruptcy laws in the U.S. will likely continue to be revised from time to time to adjust for economic, social, and behavioral conditions, and to provide creditors with greater certainty of outcomes, as well as relief for debtors. Pending policy proposals may fundamentally alter the treatment of secured (specifically mortgage) debt in bankruptcy cases. However, further research, when appropriate data are available, is required to determine with certainty the impact of the 2005 reforms on the current mortgage foreclosure crisis.

NOTES

1 See www.abiworld.org.

2 Ibid.

3 Ibid.

4 Ibid.

5 Ibid.

6 Ibid.

7 Testimony of Katherine Porter, associate professor, University of Iowa College of Law before the U.S. House Subcommittee on Financial Institutions and Consumer Credit, March 13, 2008. Accessed at www.house.gov./apps/list/hearing/financialsvcs-dem/porter031308,PartIC.,secondparagraph on January 15, 2009.

8 Dan Margolies, The Kansas City Star (1/12/2009) paraphrasing Donald P. Morgan, research officer at the New York Fed (article entitled "U.S. mortgage meltdown linked to 2005 bankruptcy law).

9 Accessed at www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDis on January 15, 2009.

10 Karen Redmond, National Bankruptcy Research Center.