

Testimony of
Mr. Todd Zywicki

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Bio

TODD J. Zywicki is Professor of Law at George Mason University School of Law and Senior Fellow of the James Buchanan Center, Program on Politics, Philosophy, and Economics. From 2003-2004, Professor Zywicki served as the Director of the Office of Policy Planning at the Federal Trade Commission. He teaches in the area of Bankruptcy, Contracts, Commercial Law, Business Associations, Law & Economics, and Public Choice and the Law. He has also taught at Georgetown Law Center, Boston College Law School and Mississippi College School of Law and is a Fellow of the International Centre for Economic Research in Turin, Italy. He has lectured and consulted with government officials around the world, including Italy, Japan, and Guatemala. Professor Zywicki was is a Member of the United States Department of Justice Study Group on "Identifying Fraud, Abuse and Errors in the United States Bankruptcy System."

Professor Zywicki clerked for Judge Jerry E. Smith of the U.S. Court of Appeals for the Fifth Circuit and worked as an associate at Alston & Bird in Atlanta, Georgia, where he practiced bankruptcy and commercial law. He received his J.D. from the University of Virginia, where he was executive editor of the Virginia Tax Review and John M. Olin Scholar in Law and Economics. Professor Zywicki also received an M.A. in Economics from Clemson University and an A.B. cum Laude with high honors in his major from Dartmouth College.

Professor Zywicki is the author of more than 50 articles in leading law reviews and peer-reviewed economics journals. He is one of the Top 50 Most Downloaded Law Authors at the Social Science Research Network, both All Time and during the Past 12 Months. He served as the Editor of the Supreme Court Economic Review from 2001-02. He has testified several times before Congress on issues of consumer bankruptcy law and consumer credit and is a frequent commentator on legal issues in the print and broadcast media, including the Wall Street Journal, New York Times, Nightline, The Newshour with Jim Lehrer, CNN, CNBC, Bloomberg News, BBC, The Diane Rehm Show, and The Laura Ingraham Show. He is a contributor to the popular legal weblog The Volokh Conspiracy. He is currently the Chair of the Academic Advisory Council for the following organizations: The Bill of Rights Institute, the film "We the People in IMAX," and the McCormick-Tribune Foundation's "Freedom Museum" in Chicago, Illinois. He was elected an Alumni Trustee of the Dartmouth College Board of Trustees.

Mr. Chairman and Honorable Senators:

It is my pleasure to testify today on a one-year retrospective on the implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). BAPCPA was enacted last year to address two decades of rising consumer bankruptcy filing rates and rising concerns about the presence of fraud and abuse in the consumer bankruptcy filings system. BAPCPA was enacted by broad bipartisan majorities in both houses of Congress and after nearly

eight years of hearings and consideration by Congress.

The goals of BAPCPA were twofold: to preserve bankruptcy relief for those who need it while reducing fraud and abuse of the bankruptcy system by those who do not. I understand the purpose of today's hearing to be to address whether BAPCPA has succeeded in realizing these two goals. We have had only one year of experience with BAPCPA, of course, so any judgment rendered today necessarily must be tentative. Nonetheless, one year (now 13 months) does provide an opportunity for some examination of trends and experience with the new legislation to determine whether progress is being made in the directions sought by Congress in enacting BAPCPA.

BAPCPA was designed to address a fairly obvious problem. Over the past three decades, consumer bankruptcy filings in the United States skyrocketed (see Figure 1 attached), surmounting 1.5 million in 2004. This rise in bankruptcy filing rates was during one of the most economically prosperous periods in American history, an era of economic growth, low interest rates, record wealth accumulation, and low unemployment. See Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NORTHWESTERN L. REV. 1463 (2005), available in http://papers.ssrn.com/sol3/papers.cfm?abstract_id=587901. Given this anomaly and the inability for underlying economic problems to explain the rise in filings, it appears that among the major reasons why bankruptcy filings rose during this period was the economic incentives created by the bankruptcy system itself, which provided substantial incentives to file bankruptcy while providing few safeguards against fraud and abuse. See Todd J. Zywicki, *Institutions, Incentives, and Consumer Bankruptcy Reform*, 62 WASHINGTON & LEE L. REV. 1071 (2005), available in http://papers.ssrn.com/sol3/papers.cfm?abstract_id=681483. Other factors appear to include changing social norms or "stigma" regarding bankruptcy as well as changes in the nature of consumer credit toward more national and impersonal forms of credit. Id.

In the mid-1990s Congress authorized the establishment of the National Bankruptcy Review Commission to study the American bankruptcy laws and issue proposals for reform. The NBRC, however, failed to address the problems of rising bankruptcy fraud and abuse. Beginning in the late-1990s, therefore, Congress set off on a multiyear project to enact needed reforms to the bankruptcy laws, finally culminating in the enactment of BAPCPA in April 2005, with an effective date of October 2005. Any lingering questions about whether bankruptcy filers do in fact respond to the incentives of the bankruptcy laws or have an opportunity to control the timing and necessity of their bankruptcy filings was largely put to rest in the period preceding BAPCPA's effective date, as over half a million Americans filed bankruptcy during those two weeks.

Based on the evidence and anecdotal reports that I have heard, early returns suggest that BAPCPA has been a substantial success in preserving bankruptcy relief for those who need it while reducing fraud and abuse.

Preserving Relief for Those Who Need It

BAPCPA has not provided a major obstacle to needy and deserving filers getting bankruptcy relief. Critics of the legislation predicted widespread hardship and duress if BAPCPA was enacted. Critics argued that BAPCPA would harm victims of hurricanes and other natural disasters by interfering with their ability to gain needed bankruptcy relief. Critics argued that BAPCPA would erect barriers to bankruptcy discharge and somehow harm women and children's efforts to collect alimony and child support by putting them in competition with general

unsecured creditors.

These criticisms have turned out to be largely unfounded.

First, there is no evidence that BAPCPA has provided a major obstacle to needy and deserving filers from gaining bankruptcy relief. Anecdotal evidence suggests that the cost of bankruptcy relief has increased post-BAPCPA, especially lawyers' fees. This increased cost was to be expected, as the increased accountability in the bankruptcy system and new regulations on low-cost, abusive "bankruptcy mills" would be expected to raise the cost of bankruptcy proceedings. Prior to BAPCPA, compliance with the bankruptcy laws was largely on the "honor system," predicated on voluntary debtor disclosure and cooperation. Were human nature otherwise than it is, the honor system might have worked in bankruptcy cases. But just as we learned that the honor system doesn't work when it comes to paying taxes, preventing Medicare fraud, or crime, experience taught that increased accountability was necessary in bankruptcy. And just as the presence of the IRS raises the cost of filing tax returns, the increased accountability in bankruptcy cases may have raised the cost of bankruptcy filings. Time will tell whether this increased accountability has been worth the increased cost. For the time being, however, there seems to be little evidence that this increased cost has meaningfully interfered with the ability of those who need bankruptcy relief from gaining it.

Second, BAPCPA has proven itself flexible enough to deal with major economic problems, such as hurricanes or other natural disasters. In many areas BAPCPA makes judicial decision making more "rule-bound" and channels judicial discretion in a more focused manner than in the past. But BAPCPA reserves sufficient discretion to deal with unanticipated contingencies, such as the Hurricane Katrina disaster that hit just as BAPCPA was going into effect. The United States Trustee exercised its power to waive some requirements that were impractical in light of Katrina's devastation and courts and lawyers have acted with alacrity. I am aware of no complaints of widespread lack of access to the bankruptcy courts following Katrina. Moreover, additional experience with BAPCPA will almost certainly increase the expertise of bankruptcy professionals and judges to respond to similar disasters in the future.

Third, critics stated that BAPCPA somehow would have the unintended consequence of making it harder to collect spousal support obligations post-bankruptcy by increasing the amount of debt that was nondischargeable. This argument was dubious in the first place and seems to have been based on fundamental misunderstanding of the rules governing debt collection outside bankruptcy and the priorities of different types of creditors. See Todd J. Zywicki, "Support Creditors" Under Bankruptcy Reform Law, THE VOLOKH CONSPIRACY (Nov. 17, 2005), <http://volokh.com/posts/1132237519.shtml>. Regardless, I am aware of no reports that BAPCPA has created any new problems on this front. Instead, it appears that BAPCPA has done exactly what it was intended to do, namely to increase the ability of spousal support creditors to pursue their claims in bankruptcy without the obstruction of the Bankruptcy Code.

Thus, the overall record to date indicates that BAPCPA has preserved bankruptcy relief for those who need it, even in situations of severe stress, such as with Hurricane Katrina.

Reducing Bankruptcy Fraud and Abuse

The record also indicates that BAPCPA has substantially reduced bankruptcy fraud and abuse. The decline in filing rates is impressive (see Figure 2, attached). Immediately following the surge of filings in October 2005 was a dramatic drop in filing rates, as many of those who filed in October did so strategically in order to beat the change in the law. Filings have gradually begun to rise again, but remain at less than half of their pre-BAPCPA rate. Moreover, weekly filings

have remained largely constant for approximately eight months. This lack of any discernible upward trend is especially surprising given certain events in the economy that might be expected to exert upward pressure on bankruptcy filing rates, such as a general rise in interest rates (especially by causing an upward tick in adjustable-rate loans), stagnant housing prices, and new regulations imposed by the Federal Reserve in January that increased the mandatory minimum payment on credit card loans. All of these factors would be expected to increase bankruptcy filing rates, yet filings remain down and constant. Nor am I aware of any evidence of any substantial rise in nonbankruptcy delinquencies or defaults as would be expected if consumers in need of filing bankruptcy yet were unable to do so.

BAPCPA sought to attack the problem of bankruptcy fraud and abuse through several of well-targeted reforms that try to eliminate fraud and abuse where most present while leaving good-faith filers unaffected. Based on the limited information we have to date it appears that these many reforms have generally succeeded in weeding out abusive filers while leaving the basic integrity of the system intact. The dramatic drop in bankruptcy filing rates suggests that these reforms have done so by deterring fraudulent debtors from filing bankruptcy or by redirecting debtors to nonbankruptcy alternatives. Each of these targeted reforms may be responsible individually for diverting only 5-10% of debtors away from bankruptcy; cumulatively, however, they may account for the substantial drop in bankruptcy filing rates.

Anecdotal reports suggest that the following reforms imposed by BAPCPA may explain the decline in fraudulent and abusive filings:

? Fraud: BAPCPA created a host of new rules and procedures to attack the problem of bankruptcy fraud, such as requiring filing of tax returns, pay advices, and other information to make it easier to detect and pursue fraud. Increased efforts by USDOJ to prosecute bankruptcy fraud, such as "Operation Truth or Consequences," may have also contributed to a decrease in fraudulent filing. These new tools likely have deterred many fraudulent filers from filing.

? Abuse: Through the system of means-testing eligibility for Chapter 7 relief, BAPCPA requires those debtors who earn above the state median income and can repay a substantial portion of their unsecured, nonpriority debt to do so in Chapter 13. I am aware of no comprehensive data on the effects of means-testing so far. Nonetheless, it appears that at least some high-income debtors with repayment capacity who would have filed bankruptcy in the past are now choosing not to file bankruptcy, but rather to repay their debts in some other way. Early evidence suggests that Chapter 13 filings have risen as a percentage of bankruptcy filings (rising from approximately 30% to 40-45%), suggesting that means-testing may be pushing some filers into Chapter 13. Some critics charged that pushing debtors into Chapter 13 would be unwise, given the high failure rate of Chapter 13 plans. Based on the evidence that I have seen and anecdotal reports, despite the rise in Chapter 13 filings as a percentage of cases there has been no discernible increase in the Chapter 13 dismissal rate. Any verdict on the impact of means-testing is tentative, given the sharp drop in overall filings; nonetheless, experience to date is consistent with Congress's goals in imposing means-testing.

? Repeat Filings: BAPCPA sought to reduce bad-faith repeat filings in several ways, such as by extending the time between eligibility for Chapter 7 discharge and by streamlining the process for creditors to gain relief from the automatic stay for repeat filings. I am aware of no systematic evidence on changes in the volume of repeat filers post-BAPCPA., but pre-BAPCPA research indicated that the number of repeat filers in bankruptcy was substantial. Anecdotal reports suggest that there has been a substantial reduction in the number of repeat filers.

? Cramdown: BAPCPA limits the ability to cramdown certain secured consumer debts, most

typically auto loans. It may be that fewer debtors are availing themselves of bankruptcy because of this reduced ability to cramdown auto loans. This seems somewhat unlikely and is contradicted by the increased fraction of Chapter 13 cases as a percentage of all cases filed.

? Domestic Support Creditors: Pre-BAPCPA law provided several loopholes for those seeking to discharge certain domestic support obligations or to gain the benefit of the automatic stay to frustrate their collection. This gamesmanship and abuse appears to have disappeared under BAPCPA, likely deterring at least some debtors who would have filed bankruptcy for this improper purpose.

? Consumer Credit Counseling: One of the more controversial aspects of the new law has been the requirement of pre-bankruptcy consumer credit counseling and the completion of a financial management class as a condition for discharge. Reports suggest that some debtors have been redirected into debt-management plans and away from bankruptcy by this requirement. The requirement that debtors complete a financial management class as a condition for discharge is intended to reduce filings in the long run. It is too early to tell how effective this requirement will turn out to be.

? Changing Social Norms: It may also be that BAPCPA, and the widespread publicity it received, may have had the effect of changing social norms regarding the social acceptability of bankruptcy. It may be that one effect of BAPCPA was to help reassert values of thrift and personal financial responsibility while reasserting some of the social "stigma" associated with filing bankruptcy. Many believe that law has this "expressive" function of changing social norms. These effects are difficult to measure or demonstrate, but may be present in the current case.

A final factor that has likely led to a decrease in bankruptcy filing rates has been general misunderstanding among the public about the effects of BAPCPA. Anecdotal reports indicate that many consumers believe that bankruptcy relief is no longer available or is now intolerably onerous. This is untrue, of course. In large part, this misinformation appears to have been spawned by agenda-driven media reports and some bankruptcy experts who actually sought to create this misimpression in an attempt to try to build public opposition to bankruptcy reform. These efforts were both unsuccessful and irresponsible. Nonetheless, a public impression remains that bankruptcy is no longer a viable option. This has likely led to a temporary dampening of bankruptcy filing rates. As day follow the night, bankruptcy professionals have now changed their tune and recent advertising by bankruptcy professionals stress that bankruptcy relief is still available to those who need it. It is likely that over time this misimpression about the law will erode and that the contribution of this effect to lower filing rates will prove temporary.

Overall, the record to date indicates that Congress has effectively targeted bankruptcy fraud and abuse through the various reforms enacted in BAPCPA.

Remaining Areas for Improvement

Experience to date thus suggests that BAPCPA has been quite successful in accomplishing its primary goals of preserving bankruptcy relief for those who need it while reducing bankruptcy fraud and abuse. On the other hand, there several minor "glitches" in drafting and implementation of the statute have been reported, where statutory language has been ambiguous or less than artfully drafted. Ambiguities are to be expected in any complex statutory reform, whether of the bankruptcy code, tax code, Medicare reform, campaign finance reform, or any other comprehensive federal law. BAPCPA appears to be no more prone to these ambiguities than other similar legislation. The questions that have arisen under BAPCPA, for instance, appear

to be minor when compared to some of the major constitutional and statutory interpretation issues that arose under the 1978 Bankruptcy Code, the last previous overhaul of the bankruptcy laws. In *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), the United States Supreme Court struck down as unconstitutional the entire structure of the judicial system created under that legislation. Although some minor constitutional questions have arisen under BAPCPA related to the First Amendment and client counseling issues, BAPCPA does not appear to raise the profound constitutional infirmities of the 1978 Code. Indeed, litigation continues to this day as courts construe the linguistic ambiguities contained in the 1978 Code. Over the past two decades the Supreme Court has confronted a steady stream of litigation involving interpretation of the Bankruptcy Code covering almost every important area of consumer bankruptcy practice, from the calculation of the proper cramdown interest rate in a Chapter 13 plan, to the valuation of collateral in a Chapter 13 plan, to the meaning of "willful and malicious injury" for purposes of nondischargeability. Indeed, just last month the United States Supreme Court heard oral arguments in *Maramba v. Citizens National Bank of Massachusetts*, a case raising a question of statutory interpretation of the 1978 Code on the question of whether a judge can prohibit a bad-faith conversion of a debtor's case from Chapter 7 to Chapter 13.

Moreover, my review of the extant caselaw interpreting BAPCPA indicates that in most cases where the statutory language is inartfully drafted courts have been able to readily discern Congress's intent and to make sense of the statute in light of that intent. Ambiguities remain and I would urge this body to consider technical amendments at some point in the future to clarify some nagging questions of construction. Nonetheless, BAPCPA's flaws have proven to be relatively minor by the standards of prior bankruptcy legislation. Unlike the 1978 Code, however, there appears to be no major constitutional flaws in BAPCPA nor insoluble questions of statutory interpretation fundamentally different from those raised by the 1978 Code. In addition, BAPCPA provides for interlocutory appeal to the Federal Courts of Appeals to resolve contested issues of law, which should resolve lingering ambiguities and uncertainties more rapidly than in the past.

Conclusion

As BAPCPA passes its one year anniversary, experience to date suggests that it has been largely successful in accomplishing its stated and worthwhile goals. It appears to have preserved bankruptcy relief for those who need it while reducing fraud and abuse in the system. One year is plainly too early to render a final verdict on the reforms and further empirical analysis will be necessary to determine whether the reforms are effective in accomplishing their goals in the long run. Nonetheless, after one year BAPCPA appears to be on the right track.