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"Credit Cards and Bankruptcy: Opportunities for Reform"
Hearing of the United States Senate Committee on the Judiciary
December 4, 2008

Americans owe over $13.1 trillion on their home mortgages, credit cards, automobile loans, and all other forms of household debt. [1] We owe more in household debt than our annual national personal income, a circumstance that was not true as recently as 2003.[2] Even if we devoted all of the national income for one year to repayment and did not spend any money on housing, food, utilities, health care or any of the other necessities of life, it would not be sufficient to retire our household debt. We have gone from a society where most consumer borrowing was episodic and for special purchases to a society where many families have to use credit to pay for ordinary household expenses and are permanently indebted. Over half of American families with a credit card now carry a monthly credit balance.[3] The attitudinal change toward consumer debt is one of the greatest cultural shifts of the past thirty years. We now found ourselves in an economic crisis that has its origins in this orgy of consumer borrowing, and before it is over this crisis may exceed the upheaval and privations of the Great Depression.

We have come to this situation largely because of historical accident. Laws passed for one purpose in an earlier time were used for different purposes in a later era. The story begins when, amidst the chaos of the Civil War, Congress passed the National Bank Act of 1864 to create a banking system that would stabilize the nation's finances.[4] A banking system that the federal government controlled was controversial, and there was concern that states might use

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[1] See Figure 1 in the Appendix. These data are taken from Federal Reserve Statistical Release G.19, *Consumer Credit* (available at http://www.federalreserve.gov/releases/g19/) and Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* (available at http://www.federalreserve.gov/releases/z1/).
[2] See Figure 2 in the Appendix.
[3] Brian Bucks, Arthur B. Kennickell, and Kevin B. Moore, *Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances*, Federal Reserve Bulletin, Feb. 2006, at A1, A31.
[4] National Bank Act of 1864, ch. 106, 13 Stat. 99.

their legislative powers to defeat the national banking system before it got established. Consequently, Congress included a number of provisions to protect the new national banks, and among these provisions was a rule that prevented states from applying lower interest rate caps to the nationally chartered banks than the states could apply to their locally chartered state banks.[5] Interstate lending was of limited concern to the 1864 Congress. The information technology of the age necessarily limited the extent to which a national bank might lend to customers in distant markets.

Over one hundred years later, changes in information technology and the development of a credit reporting system had made it possible for lenders to assess the creditworthiness of faraway borrowers. At the same time, borrowers could find faraway lenders as sophisticated marketing and advertising techniques made it possible for consumers to learn of lenders in another state. States had effective usury laws that limited the interest rates that lenders could charge consumers, but that was about to change. In a 1978 case called *Marquette National Bank v. First of Omaha Service Corp.*,[6] the Supreme Court turned what Congress intended to be a protective shield into a sword, ruling that the National Bank Act allowed national banks to export the most lenient usury laws any other state of the Union.

The immediate consequence of *Marquette National Bank* was that the Nebraska bank that litigated the case could charge Minnesota consumers an 18% interest rate although Minnesota law capped interest rates at 12%. Because of the Supreme Court's interpretation of the 114-year old National Bank Act, the Nebraska bank could charge the interest rate allowed by Nebraska to any citizen of the United States even if that person lived in a state whose legislature had made a judgment to give its citizens more protection from usurious interest rates. Perhaps only in retrospect the next step seemed inevitable and made *Marquette National Bank* one of the more obscure Supreme Court decisions to have some of the most far-reaching consequence. After the Court's decision, consumer lenders rushed to locate national banks in states that traditionally had no usury law or that had recently repealed their usury statutes at the behest of the

[5] *Id.* § 30, 13 Stat. at 108. The provision remains codified at 12 U.S.C. § 85.

[6] 439 U.S. 299 (1978). For a discussion of the *Marquette National Bank* decision, see Robert M. Lawless, "Marquette National Bank v. First of Omaha Service Corp." in *Encyclopedia of the Supreme Court of the United States* (David Tanenhaus ed., 2008).

consumer lending industry. By relocating to states with no usury statute, lenders could charge whatever interest rate they could extract from consumers across the country. Just in the past month, Citigroup announced it would raise interest rates to its credit card customers to try to make up for lost profits from the economic crisis.[7] Thus, we went from a system where each state could have its own usury law to a system where federal law preempted the choices states had made about the maximum rates of interest that their citizens should pay. In this instance, however, federal preemption meant no regulation as consumer lenders raced to the bottom to find the states that would let them charge whatever interest rate they pleased.

After *Marquette National Bank*, consumer lending took off. With lenders now able to charge exorbitant rates of interest, even marginal borrowers could find lenders willing to extend massive amounts of consumer credit. Consumer lending euphemistically was said to be "democratized," a term that was intended to reflect the fact that persons who previously had been cut off from credit were now able to borrow. By using the term "democratization," the implication was that the huge increases in consumer debt were a positive social development, but that claim ignored the costs that came with these huge increases.[8] Bankruptcy filings increased sharply.[9] The costs of consumer credit rose as lenders discovered that consumer interest rates were unresponsive to changes in changes in supply and demand. In 1996, the Supreme Court extended *Marquette National Bank* to credit card fees, meaning lenders now could extract huge penalty fees from consumers. [10] Late fees for credit cards have more than doubled since 1996 and averaged $35 as of two years ago.[11] Fee income has become a major profit center for the credit card industry. The traditional lending model where consumer lenders made their money by being repaid and earning a profit off the interest is now outdated.

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[7] *See* Eric Dash, *Despite Pledge, Citigroup to Raise Credit Card Rates, Blaming 'Difficult Environment,'* N.Y. Times, Nov. 14, 2008, at B1.
[8] An overview of the rise in consumer lending in the 1980s can be found at David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 Am. Bankr. L.J. 311, 332-42 (1999).
[9] Over the long-term, bankruptcy filings rise hand-in-hand with increases in consumer credit. *See* Robert M. Lawless, *The Paradox of Consumer Credit*, 2007 U. Ill. L. Rev. 347 (2007). See also Figure 3 in the Appendix.
[10] Smiley v. Citibank (South Dakota), 517 U.S. 735 (1996).
[11] *See* Government Accountability Office, *Credit Cards: Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers*, at 18 (September 2006).

The best customers are those who pay late, incurring high penalty default rates of interest and late fees.

Our task today is to focus on how Congress can shape the bankruptcy law to be more responsive to consumers who find themselves awash in debt and especially high-cost credit card debt, but we need to remember how we came to have a consumer financial system where over 1 million households each year can find themselves needing bankruptcy relief. These consumers have been caught up in a huge regulatory shift that allowed consumer lending under very permissive rules. The entire picture is complex, and changes to the bankruptcy laws should only be part of the solution. Letting the states again experiment with interest-rate regulation would be one step in the right direction. Although some may quibble with the wisdom of usury laws despite their long tradition, it is difficult to quibble with allowing states to make that judgment for themselves and harness the power of the states to experiment with different regulatory regimes so the best governmental initiatives may be passed along to everyone.

Before turning specifically to changes in the bankruptcy law that can help consumers, it is important to establish a few facts about what we see from consumers who have to turn to the bankruptcy system to escape crushing debt loads. My colleagues and I recently published a study describing what happened to consumers after the 2005 changes to the bankruptcy law. Our study was the first to be able to use a national random sample of bankruptcy filers from 2007.[12] Bankrupt debtors represent a slice of middle-class America, with modest incomes and modest homes. The typical debtor shows up in bankruptcy court with $27,000 in annual income[13] and assets of $53,000.[14] Against, these modest resources, the typical debtor has almost $34,000 in unsecured debt[15] such as credit card, utility, and medical bills and another $35,000 in secured debt.[16] The typical homeowner in bankruptcy has a house worth $110,000 with a

[12] *See* Robert M. Lawless, et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 Am. Bankr. L.J. 349, 353-56 & App. I (2008) (describing methodology).
[13] *Id.* at 404. Because a few outliers skew the average values for the measurements of assets, debt, and income, I am following the convention of the article by reporting median values as the typical filer.
[14] *Id.* at 365. Figure 4 in the Appendix shows these figures.
[15] *Id.* at 367, Fig. 7.
[16] *Id.* at 404.

mortgage of $102,000.[17] Considering everyone in our study, the typical household in bankruptcy had debt equal to 3.3 years of income.[18]

The 2007 study followed research cohorts in 1981, 1991, and 2001, which allowed us to compare bankruptcy filers in these different years. We find relatively flat incomes among bankruptcy filers over this time but increasing levels of debt. Each time we have done our study, we have found consumers showing up in bankruptcy court in worse shape than the previous study.[19] The 2005 changes to the bankruptcy laws were sold to Congress as a way to separate the "can pay" debtors from the "can't pay" debtors. Despite the opinions of experts who did not see widespread abuse in the bankruptcy system, we were told that the 2005 changes to the bankruptcy law would force debtors to pay as much as they could to their creditors. Instead of forcing "can pays" out of the bankruptcy courts (or at least into chapter 13 for partial debt repayment) and leaving only those with more modest incomes eligible for bankruptcy, the data show no change in the income levels of bankruptcy filers after the 2005 amendments. These findings thus cast doubt on the suggestion that those purged from the bankruptcy courts were high-income deadbeats. Instead, they appear to have been ordinary American families in serious financial distress. The real effect of the 2005 bankruptcy law was to increase the cost and hassle of filing bankruptcy, extending the amount of time that consumers would suffer before seeking bankruptcy relief. We find evidence of that delay in our study as well, with over 44% of our debtors telling us that they seriously struggled for more than two years before filing bankruptcy, where only 32% of the debtors made such a statement before the 2005 laws.[20]

This hearing appropriately focuses on how we can improve our bankruptcy laws to help households deal with high-cost credit card debt. When you improve the bankruptcy laws, you help improve the lives of those struggling with credit card debt. The typical bankruptcy filer in our study had unsecured debt—most of which was credit card debt—in an amount that was greater than the household's annual income. Bankruptcy is not an easy solution and requires a

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[17] *Id.* at 365.
[18] *Id.* at 371-72.
[19] See Figure 5 in the Appendix.
[20] *Id.* at 381. See also Figure 6 in the Appendix.

household to turn over all of its assets or income in repaying creditors. When bankruptcy is necessary, it is an escape valve from the endless cycle of astronomically high interest rates, penalty fees, and ever-increasing balances that credit cards give their customers. The most profitable credit card customer is a customer who is having trouble making payments and thereby paying the highest interest rates and fees. The longer credit card companies can keep customers paying these high interest rates and fees, the more profit they make. That is why credit card companies oppose changes to the bankruptcy law,[21] but changes should be made. These changes should include:

- The Consumer Credit Fairness Act,[22] introduced by Senators Whitehouse and Durbin, would subordinate high-cost credit transactions to the claims of all other creditors in bankruptcy. This bill would help to address the problem of abusive loans made possible by the permissive regulatory scheme created by *Marquette National Bank*. In its current form, the bill would subordinate any loan on which the interest and fees were more than 15% plus the rate on 30-year Treasury obligations (up to a maximum of 36%). It also would serve the very helpful purpose of excusing from the section 707(b) means test a consumer's bankruptcy that was caused by a high-cost credit transaction. Although consumer lenders do not expect large recoveries in bankruptcy and would continue to charge exorbitant interest rates despite this proposal, the bill would help many consumers through its exemption of the means test and would be a powerful statement that the federal bankruptcy courts would not be used as a vehicle for consumer lenders to collect exorbitant rates off the backs of the middle class.
- Perhaps the most helpful thing Congress could do is to take measures that would lower the costs of filing bankruptcy. Making it easier for attorneys to provide legal services to consumer debtors will drive down attorneys' fees and increase accessibility to the bankruptcy courts. Congress should remove unnecessary responsibilities from bankruptcy attorneys to vouch for the minute details in their clients' lengthy financial

[21] Ronald J. Mann, *Consumer Bankruptcy and Credit in the Wake of the 2005 Act: Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. Ill. L. Rev. 375
[22] S. 3259, 110th Cong., 2d Sess.

statements (Bankr. Code § 521). Bankruptcy attorneys should not be treated as suspicious "Debt Relief Agencies" as Bankruptcy Code §§ 526-528 now do. Provisions such as Bankruptcy Code § 521 should be rewritten so they do not create unnecessary paperwork for debtors to collect and attorneys to organize and file. Also, Congress should return the filing fees for chapter 7 and chapter 13 to their pre-2005 levels. The $299 it takes to file chapter 7 and $274 for chapter 13 are large amounts of money to someone who is at the end of their financial rope. Even a modest remittance to $235 for chapter 7 and $217 for chapter 13 would be a big help.

- Proposals to make specific exceptions to the means test, like the Consumer Credit Fairness Act does for consumer bankruptcies caused by high-cost consumer credit will provide meaningful relief to some consumers. Congress could go much further and repeal in its entirety the means test of Bankruptcy Code § 707(b), which determines eligibility for chapter 7. As our study shows, the means test has failed in its screening function because there were not large numbers of "can pay" debtors in the system. The means test is only another hoop that debtors and their attorneys must jump through before getting to bankruptcy court. The related use of the means test calculations to determine the amount of payments in chapter 13 (Bankr. Code § 1325(b)) also should be dropped. Both sections 707(b) and 1325(b) are generating litigation as bankruptcy courts try to apply the rigid and arcane minutiae of each provision to the many experiences of real-life human beings. This litigation only further drives up the cost of bankruptcy filings. Congress should restore the discretion of bankruptcy judges to decide when chapter 7 cases are abusive and when a chapter 13 debtor needs to contribute a greater portion of their income toward debt repayment.
- The prebankruptcy consumer credit counseling required by section 109 should be repealed. The prebankruptcy credit counseling has turned out to be what it was destined to be—a mere formality. In the vast majority of cases, the prebankruptcy credit counseling is nothing more than a telephone call or Internet session that just adds hassle and another $50 cost before filing bankruptcy. The postbankruptcy course in personal

financial management that Bankruptcy Code § 727 put in place has much better promise to change debtors' behavior after a bankruptcy filing.

- The Helping Families Save Their Homes in Bankruptcy Act[23] would help debtors use chapter 13 as a tool to keep their homes by restoring to bankruptcy judges the power to put a mortgage lender in the same position it would be after a foreclosure but leaving the debtor in the home. Under this legislation, a bankruptcy judge could order a debtor to pay off a home mortgage in an amount equal to the value of the residence. The debtor benefits because to the extent the value of the mortgage exceeded the value of the house, the debt would be forgiven. The mortgage lender benefits by getting a promise to pay equal to the value of the house, which is what it would have had if it sold the house outside of bankruptcy. This simple change would bust the power of mortgage lenders to extort payments from debtors and benefit consumers widely by giving borrowers increased bargaining leverage to renegotiate mortgages before they got to bankruptcy court. In chapter 13, bankruptcy judges already have these powers with respect to mortgages on vacation homes or secured loans on a debtor's boat. This bill would only extend that power to mortgage loans on a debtor's house.
- Congress should amend chapter 13 to ensure that small business owners do not have to give up their business to fund a chapter 13 plan. To clear up any ambiguity, Congress should make clear in section 1325 that the business expenses of a small business owner are deductible expenses in determining the amount of "disposable income" a debtor has to devote to a chapter 13 plan. If the means test is not repealed, similar amendments should be made to section 707(b) to ensure that a small-business owner only has to consider his or her net income (and not gross revenues) in determining eligibility for chapter 7.

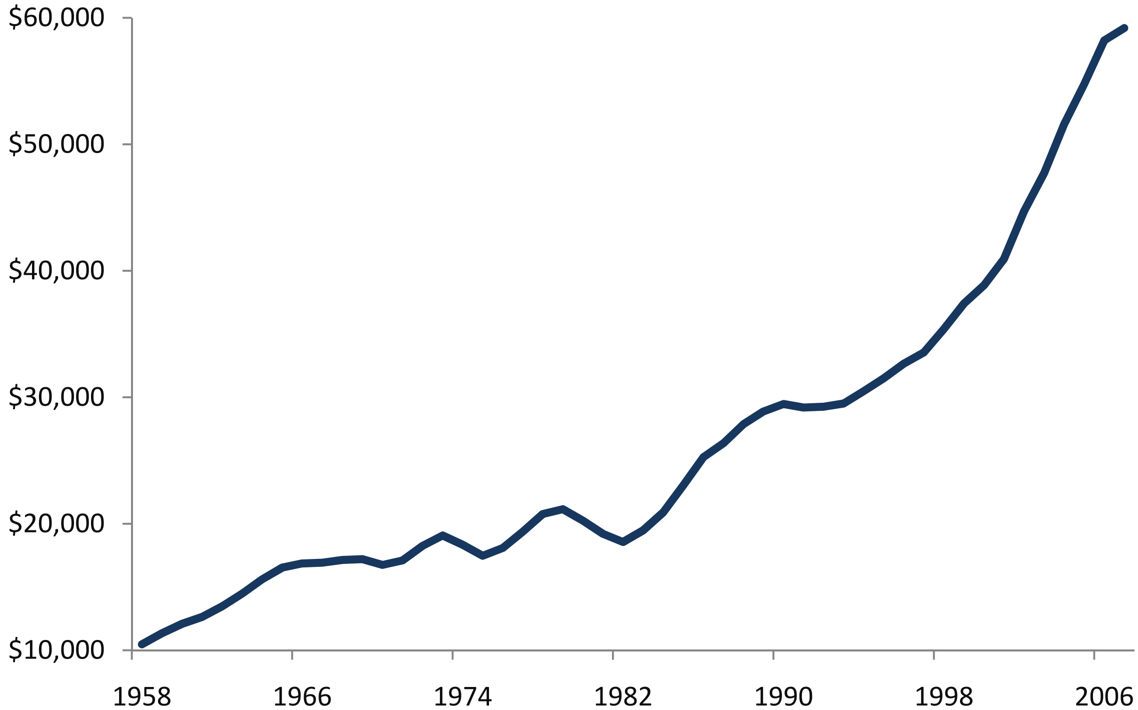
[23] S. 2136, 110th Cong., 2d Sess.

APPENDIX

Household Debt per Adult, 1958-2007

Figure 1

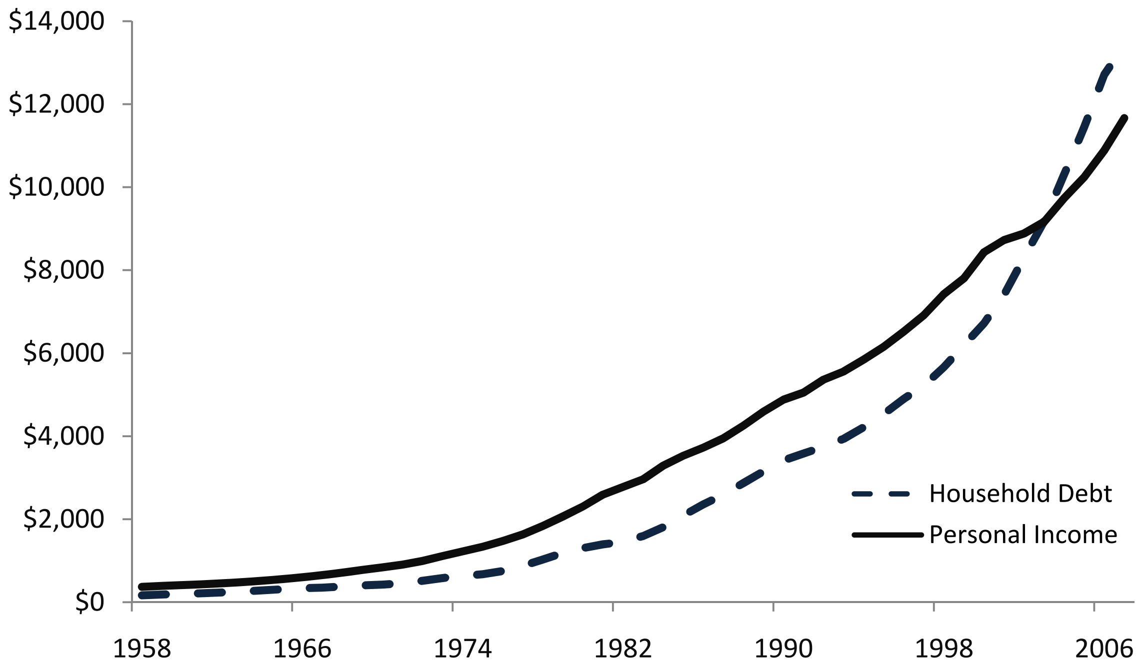
Figure 1 shows the amount of household debt per adult citizen (defined as all adults over the age of 18) of the United States beginning in 1958 and through the year 2007. Household debt is defined as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. Data are inflation adjusted using the Consumer Price Index—All Urban Consumers (CPI-U) from the Bureau of Economic Analysis. Population data are from the U.S. Census Bureau.



Household Debt Relative to Personal Income (in billions), 1958-2007

Figure 2

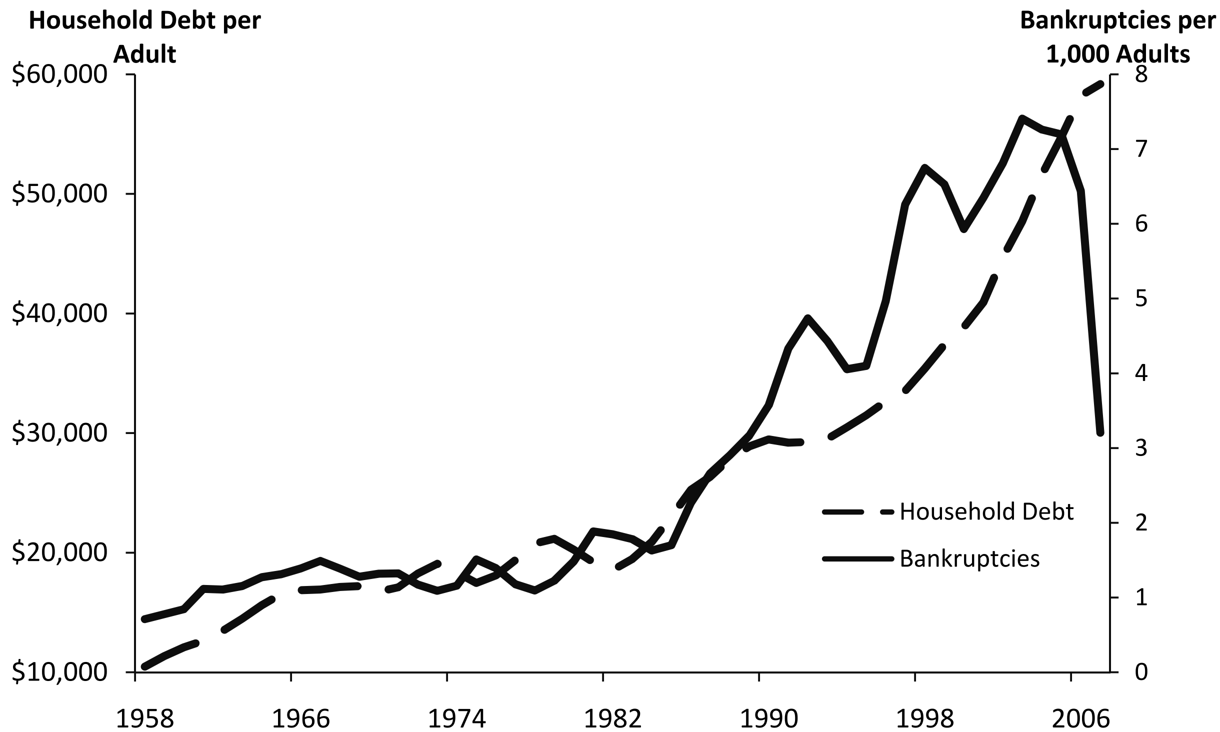
Figure 2 compares the outstanding household debt to national personal income. Household debt is defined as in Figure 1 as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. National personal income is from the Bureau of Economic Analysis. Both amounts are presented in nominal dollars (i.e., not inflation adjusted) and represent total amounts in billions.



Household Debt and Bankruptcy Filing Rates, 1958-2007

Figure 3

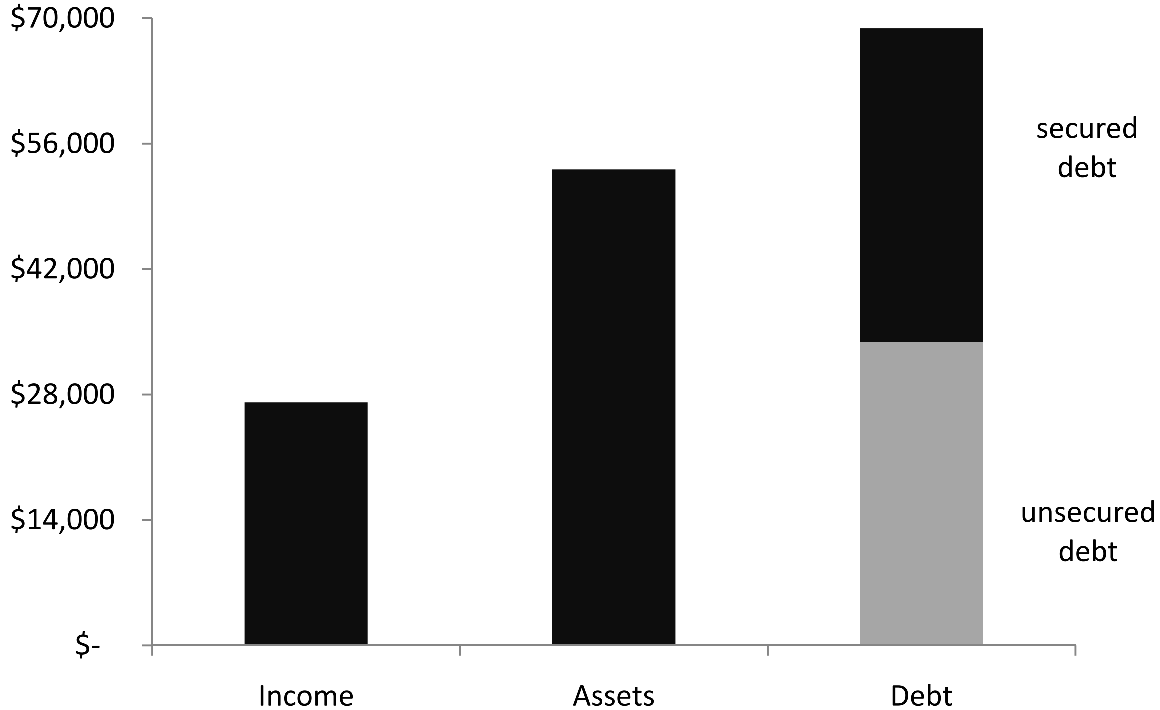
Figure 3 compares the outstanding household debt per adult to bankruptcy filing rates per 1,000 adults. Household debt is defined as in Figure 1 as the amount of home mortgage debt from Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States* plus the amount of consumer credit from Federal Reserve Statistical Release G.19, *Consumer Credit*. The household debt data are inflation adjusted using the Consumer Price Index—All Urban Consumers (CPI-U) from the Bureau of Economic Analysis. The bankruptcy filing data represent nonbusiness filings from the Administrative Office of U.S. Courts for the 12-month period ending June 30 of each year. Population data are from the U.S. Census Bureau.



Median Financial Characteristics of Bankruptcy Filers, 2007

Figure 4

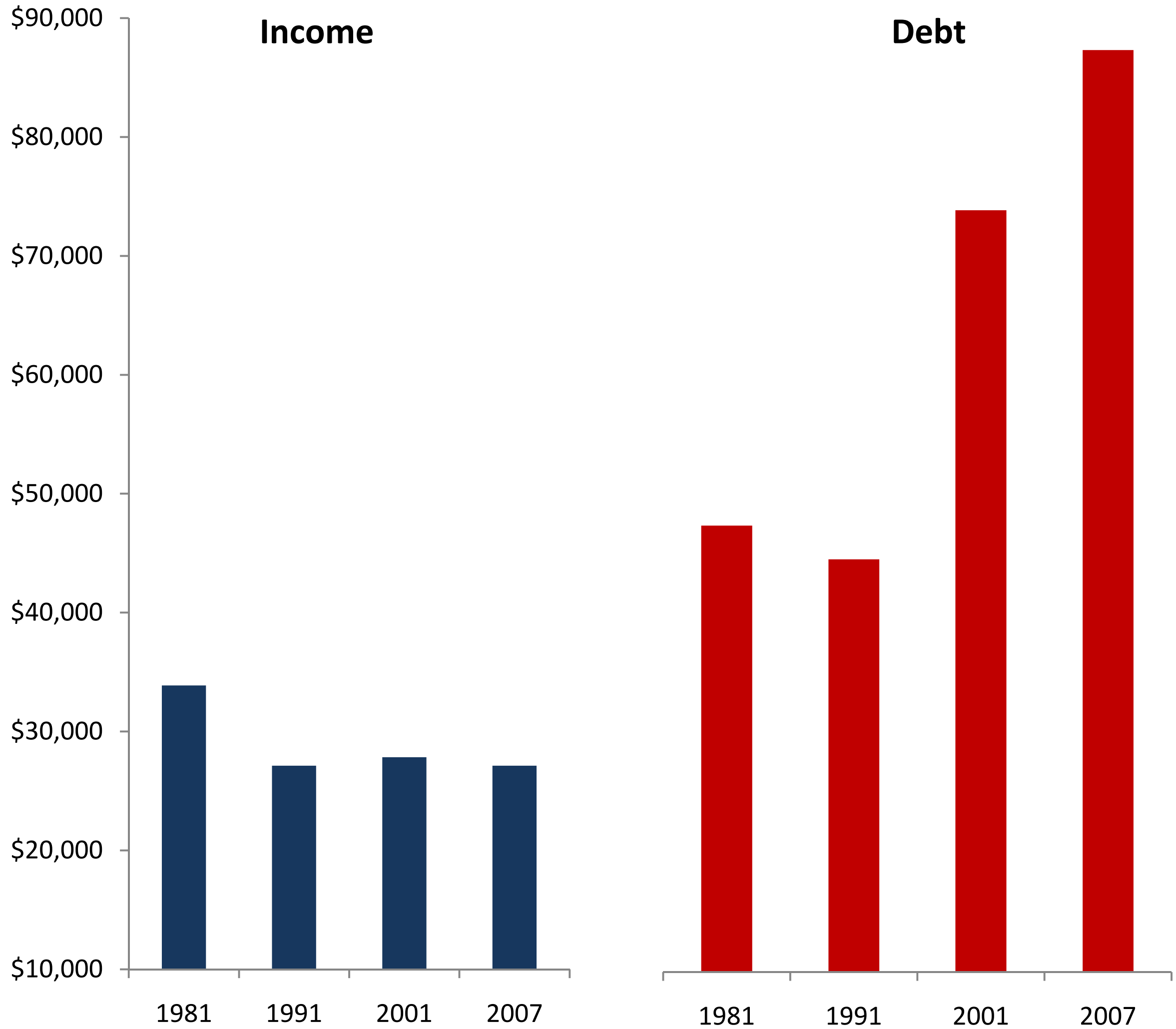
Figure 4 shows the median amount of income, assets, and debt data as reported on the bankruptcy schedules from a national random sample of bankruptcy filers in the Consumer Bankruptcy Project



Changing Income and Debt of Median Bankruptcy Filer

Figure 5

Figure 5 shows the changing amounts of income and debt across the four cohorts of the Consumer Bankruptcy Project. Income and debt data are from the bankruptcy schedules of bankruptcy filers.



Amount of Time Struggling Before Bankruptcy

Figure 6

Figure 6 shows the responses from the 2001 and 2007 cohorts of the Consumer Bankruptcy Project on how long each respondent estimated they struggled with financial problems before filing bankruptcy. The black bar shows the 2001 responses, and the light-colored bar shows the 2007 responses.