Testimony of

The Honorable Thomas Small

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on behalf of the

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Credit Cards and Bankruptcy: Opportunities for Reform

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The National Bankruptcy Conference is grateful for the opportunity to participate in this hearing and to comment on S. 3259. The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and on any proposed changes to those laws. Attached to this statement is a Fact Sheet about the Conference, including a list of its Conferees.

The NBC strongly supports the efforts of the bill's co-sponsors to address the effects of high cost credit on consumers generally and in bankruptcy cases. High cost credit is often the cause of a debtor's bankruptcy. High cost credit permits lending to borrowers whose ability to repay is tenuous. While such lending may provide benefits to some borrowers and to the economy, its effect on many borrowers and, as we are currently seeing, on the economy generally and therefore on all Americans, can be devastating, resulting in bankruptcy for some borrowers who would have maintained financial health but for the additional, aggressively marketed credit. In addition, the credit's high cost itself may push some borrowers who are able to handle ordinary credit over the brink of solvency and into bankruptcy. High cost creditors should not be rewarded in bankruptcy to the detriment of debtors and their other creditors. In bankruptcy, high cost credit can be unfair to other creditors, who share pro rata in bankruptcy distributions, to have their recoveries diminished when the claims of high cost lenders are inflated by exorbitant interest rates, fees and charges. Bankruptcy courts are courts of equity, and there is a point at which excessive fees and charges should not be permitted.

As an important matter of bankruptcy policy, the NBC believes that legislation that addresses a broad financial problem such as that addressed by S. 3259 should apply generally, not only in bankruptcy. It is an important bankruptcy policy that entitlements created and regulated under nonbankruptcy law not be materially upset and reordered in bankruptcy, unless there is a specific bankruptcy purpose for doing so. The Bankruptcy Code largely reflects that division of regulatory purposes. Disparate treatment in bankruptcy can create an independent incentive to file a bankruptcy petition when a debtor might otherwise be able to work out problems outside of bankruptcy. It can also, in some circumstances, create unfairness to the creditor whose rights are being modified only in bankruptcy. And, though Bankruptcy Code provisions such as the ones proposed by S. 3259 can have an important prophylactic effect in regulating the extension of credit, which itself is an important regulatory goal, the NBC believes that such goals are usually better and more precisely achieved through more direct regulation of the problem behavior or business practices. The Bankruptcy Code largely reflects such a division of legislative responsibility and does not attempt to regulate conduct through Bankruptcy Code provisions. Therefore, the NBC recommends that the Committee consider revising the bill to address the problem of high cost credit directly, by legislation aimed directly at the interest rates, fees, charges and practices of the high cost lenders. Non-bankruptcy alternatives, such as a national usury law (or permitting states to extraterritorially enforce state usury laws), are possible ways to deal with problems caused by high cost consumer credit. We believe that it would be the preferable way to approach the problem that this bill has so correctly identified.

That said, we recognize that the Bankruptcy Code does occasionally provide treatment of claims in bankruptcy that differs from their non-bankruptcy law entitlements. Several examples readily come to mind, including subordination of securities law claims (§ 510(b)), equitable subordination based on a creditor's inequitable conduct (§ 510(c)), limitation on real property lease and employment contract breach damage claims (§ 502(b)(6), (7)), and provision of recourse claims to nonrecourse secured lenders in chapter 11 cases (§. 1111(b)). Each of these provisions is designed to further a specific bankruptcy policy, to balance creditors' rights among themselves and as against the debtor in bankruptcy. More recently, Congress added § 502(k) to the Bankruptcy Code to permit partial disallowance of a creditor's claim if the creditor refused to negotiate a reasonable repayment plan for a consumer debtor. This provision, differing in some measure from the others referenced above, was designed to influence creditor behavior before bankruptcy in a manner intended to reduce consumer debtors' need for bankruptcy relief. Thus, Congress has not uniformly adhered to the policy of respecting nonbankruptcy rights in bankruptcy, where there is an important bankruptcy reason for departing from that policy. Because of the pervasiveness of the high cost credit problem, the NBC does not believe that this is the right issue on which to depart from that policy. We believe that the problem should be addressed more broadly.

However, because high cost credit contributes directly to the filing of many bankruptcies and has an adverse effect on other creditors in bankruptcy, the NBC believes that bankruptcy legislation to deal with high cost credit may be appropriate. If the Committee determines that the problem of high cost credit should be addressed only in the Bankruptcy Code, for the prophylactic effect it may have and for the protection in bankruptcy of the debtor and other creditors, the NBC would support S. 3259 in general. We believe that the bill as currently drafted could be improved to provide the desired protection. Although the NBC supports the goals of S. 3259, we are concerned that the bill in its current form does not address some of the more serious credit abuses, does not provide relief for consumer debtors, and could have detrimental consequences for some chapter 13 debtors. The first problem is that the definition of high cost consumer credit is not broad enough to include excessive fees charged after the initiation of the credit transaction, which in many cases are the "straw" that breaks the debtor's back. A second problem is that by only subordinating high cost credit claims but not disallowing them, the bill may help other creditors but not the debtor. Third, the bill as currently drafted may leave chapter 13 debtors who are unable to complete their repayment plans, often because of circumstances beyond their control (and, consequently, have their cases dismissed) with heavier debt loads than when they filed their petitions. Finally, the NBC, although generally opposed to "means testing" in its present form, believes that for the reasons stated below, debtors with high interest credit should not be excluded from that test.

Definition of High Cost Consumer Credit

In bankruptcy, creditors are usually paid a pro rata share of what is available for distribution. That means that high cost credit tends to reduce the payout for other legitimate creditors by inflating the amount due the high cost creditor with high interest rates, add-on fees and costs. S. 3259 strives to identify such creditors and to deal with them appropriately.

The bill proposes to borrow from the Truth in Lending Act, and so to build on the large body of case law that has developed under that well-known consumer protection provision. The NBC generally agrees with that approach.

The bill proposes to borrow the TILA-defined concept of "annual percentage rate," then to add in costs and fees incurred when the loan is first taken out, and finally to effectively "cap" that cost of credit at the lesser of one of two numbers. The first number is derived from a calculation that adds 15 percent to the yield on 30-year U.S. Treasury securities. The second number is 36 percent. Thus, automatically, credit that costs more than either of these two numbers is "high cost consumer credit." The Conference agrees that a 36% rate should be included in the definition of high cost consumer credit. The alternative cap in today's market would be around 20%, which is close to the interest rate on many ordinary credit cards. The Conference notes this for the Committee's consideration and has a concern about a rate that is too low but does not take a position with respect what percentage rate below 36%, if any, would be an appropriate level.

In addition, the NBC believes that a more comprehensive definition of high cost consumer credit is in order. Credit often becomes high cost consumer credit in the months preceding bankruptcy. As consumers fall behind on their credit cards, their payday loans, their rent-to-own contracts, and other consumer purchases, a blizzard of default interest rates, late fees, and other additional charges can cause the balance of the loan to suddenly skyrocket. Unfortunately, neither the TILA definition of APR nor the bill's reference to the costs and fees incurred at the outset of the loan includes these later-added costs.

We appreciate the sponsors' desire to have a clear, workable standard for defining high cost consumer credit. The statutory standard, however, must work on the real life facts to which it will be applied. The financial complexities involved should not be disregarded. We recommend that the definition of high cost consumer credit be expanded to cover charges such as late fees, over limit fees and default interest rates, so that it reflects the actual cost of credit to the borrower. Specifically, we suggest that including the actual cost of credit imposed within the six-month period before bankruptcy would improve the bill.

We are happy to offer our assistance to you and your staff in drafting appropriate language.

Subordination or Disallowance of Claims?

Once high cost consumer credit transactions are defined, the question becomes, how should they be treated in bankruptcy? The most effective treatment will provide both relief for debtors and fair treatment for other creditors.

As presently drafted, S. 3259 deals with high cost consumer credit by subordinating it to other debts and by avoiding any lien that secures it, with the lien retained for the benefit of the debtor's estate. This treatment would certainly prevent high cost creditors from obtaining a disproportionate payment of their claims in bankruptcy. In Chapter 7, all of the debtor's nonexempt property--including any property that was collateral for the high cost consumer credit--would be distributed to creditors, with the high cost consumer debt paid only after the other creditors had been paid in full. There would be a similar result in Chapter 13, since under the "best interest test" of 11 U.S.C. § 1325(a)(4), a debtor's plan must provide all creditors with at least as great a payment as they would have received in Chapter 7. Indeed, because of the requirement for subordination, Chapter 13 plans might well be required to pay all other debts in full before the high cost credit claims were given any payment. In this way, creditors with more reasonable finance charges would certainly be benefitted.

However, subordination does nothing to help the debtor and, in some circumstances in Chapter 13 cases, it could make the debtor's situation worse. Subordination does not help debtors because it does not reduce the total amount of the claims that must be paid. Although rare, there are Chapter 7 cases in which the debtor's estate is sufficient to pay all claims in full. In such cases, the high cost consumer debt, though subordinated, would also have to be paid in full. In other Chapter 7 cases, the debtor would surrender whatever nonexempt assets were available, and subordination would only affect the manner in which the assets were distributed. In Chapter 13, some plans provide for full payment of all creditors, and under these plans, the high cost credit claims would receive the same full payment as under current law. And in plans paying less than the full amount of the outstanding debts, subordination would not reduce the amount that the debtor was required to pay into the plan; it would affect only the distribution to creditors. Thus, the bill treats the high cost credit claims differently with respect to the debtor's creditors, but makes no corresponding adjustment for the debtor.

The NBC recommends that, instead of subordinating high cost consumer claims, they should be disallowed. Creditors, whose claims would not be diluted by the disallowed high cost credit, would receive the same distribution as if the high cost consumer credit were subordinated. In no asset chapter 7 cases and in chapter 13 cases with modest dividends, debtors would not be benefitted by disallowance. However, in large asset chapter 7 cases and full payout chapter 13 cases debtors would be significantly benefitted because the disallowed high cost credit claims would be discharged without payment. Additionally, since the severe consequence of disallowance to lenders who extend high cost consumer credit is more onerous than that of subordination it will be more likely to discourage abusive lending practices.

Liens are already avoided to the extent that a claim is not allowed, pursuant to 11 U.S.C. § 506(d), as interpreted by the Supreme Court in Dewsnup v. Timm, 502 U.S. 410, 415-16 (1992). So, if the bill provides for disallowance rather than subordination, there will be no need for a new provision avoiding any lien on high cost consumer credit transactions.

We recognize that disallowance is less consistent with the important bankruptcy policy of respecting non-bankruptcy rights in bankruptcy cases. Subordination contravenes that policy less. However, if the Committee determines that this issue should be addressed in bankruptcy, rather than more broadly, then we have concluded that disallowance is more effective to protect debtors than subordination.

In addition, beyond the failure of subordination to help debtors, there is a significant harm in any Chapter 13 case that is dismissed before the debtor obtains a discharge, as may happen where a debtor, often due to circumstances beyond his or her control, is unable to complete a three- to five-year repayment plan. This problem also exists whether a claim for high cost credit is subordi6anted or disallowed. In these dismissed cases, the claims that existed at the time the case was filed will remain subject to collection, with interest as allowed under nonbankruptcy law, reduced only by the payments that were actually made during the case. If a lien was avoided, it is reinstated under 11 U.S.C. § 349(b). The effect of subordination or disallowance in any Chapter 13 case is to pay other debts in greater amounts than the high cost consumer credit claims. So in a dismissed Chapter 13 case, the high cost consumer credit claims remain outstanding in greater amounts, with the high interest that accrued while the case was pending. The end result? The debtor will owe substantially more than if the high cost debt had not been subordinated.

The solution to this problem is to discharge all interest, fees and charges related to high cost consumer claims that accrue or are incurred post-petition in a chapter 13 case in which a plan has been confirmed. This could be easily implemented by adding a new subsection to § 1328.

Exclusion from Means Testing

Finally, the NBC believes that the current means test, set out at 11 U.S.C. § 707(b)(2)(A), is inadequate. This test has been tried, and it fails to do its job. It is a cumbersome, unnecessarily complex, and ineffective method of determining a debtor's ability to repay unsecured debt.

However, even with the faults of the means test, the NBC does not recommend an exclusion from means testing for debtors involved in high cost consumer credit transactions, as contemplated in the bill. As noted earlier, the definition of such transactions is likely to be complex, and the computations necessary to determine an exclusion from means testing based on high cost consumer credit would make the already complicated means test forms even more daunting to individual debtors. See, for example, the recent addition of Line 1C to Official Form 22A, implementing the exclusion from means testing provided for in the National Guard and Reservists Debt Relief Act of 2008, Pub. L. No. 110-438.

Conclusion

Once again, thank you for inviting the National Bankruptcy Conference to testify in this important hearing. Senate Bill 3259 offers the opportunity to do real good and to facilitate greater fairness in debtors' repayment of their debts. The Conference believes its suggestions would improve the efficacy of the bill, and we would be happy to provide any additional information on these points if the Committee would find it helpful. The Conference also would be pleased to formulate drafting proposals and assist in technical matters.