Testimony of

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With Regard to S. 257, 111th Congress,
the "Consumer Credit Fairness Act"

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"Abusive Credit Card Practices and Bankruptcy"
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I would like to thank the Members of the Subcommittee for giving me this opportunity to testify. I have been a law professor at the Pepperdine University School of Law since 1982 (though of course here I am not speaking for the University). Much of my teaching, research, and public service during those 27 years has focused on bankruptcy law, dealing both with consumer bankruptcy and with business bankruptcy. On the business side, I am the lead author of a leading law school casebook on Chapter 11 business bankruptcy. On the consumer side, I have written materials used to train lawyers to provide pro bono consumer bankruptcy services, prepared the materials for the American Bankruptcy Institute's inaugural Web-based consumer bankruptcy seminars (known as "Webinars"), and served on pro bono consumer bankruptcy committees, both for the Los Angeles County Bar Association and the ABI.

I try to consider each issue on its own merits, without favoring creditors or debtors. An article I co-authored sixteen years ago argued against allowing strip down of home mortgages in Chapter 13 bankruptcy, and I have recently testified before Congress and spoken twice at Association of American Law School Annual meetings on that subject. But I have also suggested that some other forms of modification of home mortgages in bankruptcy might be appropriate. My latest article on bankruptcy law argues strongly that holders of unsecured claims, like credit card companies in most bankruptcy cases, should not be able to add postpetition attorneys' fees and other postpetition charges to the amount of their bankruptcy claims.

My testimony has three parts. First I will discuss the general approach taken in S. 257. I will do my best to explain why I think it is not the right way to deal with high interest credit card debt. Then I will turn to technical matters. There are aspects of the language of S. 257 that should be clarified. Finally, I will comment on some of the testimony given during the last session of Congress with regard to a similar bill, S. 3259.

I

Simply put, S. 257 defines "high cost consumer credit transactions," provides for bankruptcy claims arising from such transactions to be disallowed, and provides an exemption from the mechanical means test of section 707(b)(2) for any debtor who has any debt arising from a high cost consumer credit transaction. (By the "mechanical means test" I mean the highly detailed provisions of section 707(b)(2) dealing with income and expenses that were intended to provide a clear, bright-line test for substantial abuse of the provisions of Chapter 7--thus removing the need, in at least some cases, for the Bankruptcy Court to exercise discretion.)

Unfortunately, S. 257's approach is unlikely to have any substantial effect on the conduct of credit card companies. Most consumer bankruptcy cases are "no asset" or "nominal asset" cases, in which holders of unsecured claims, like the typical credit card company, receive little or nothing under current law. They will not lose much by charging high interest rates that trigger disallowance of their claims.

Similarly, the threat that, if they charge high rates, the debtor will receive an exemption from application of the mechanical means test will not cause them to reduce their rates. Note that if even only one creditor charges high enough rates for the debtor to have a single debt arising from a high cost consumer credit transaction, all creditors lose whatever benefit they might have gotten from the mechanical means test. Is it reasonable to think that creditors will forbear from charging high rates--thus giving up the chance to collect, at least temporarily, higher payments--where they will receive no benefit from their forbearance unless all creditors similarly forbear? And what is to prevent the debtor from obtaining a little credit--fortuitously or on purpose--from a high cost creditor, thus entitling the debtor to an exemption from the mechanical means test?

The damage that is done by high cost consumer credit seems mostly to be done before a debtor files a bankruptcy petition. S. 257 simply does not seem well-suited to remedy the problem. If Congress wishes to prohibit high cost consumer credit, or to impose conditions on high cost consumer credit transactions (such as by prohibiting, for example, imposition of over-limit fees where the debtor has stopped using the card but accruing interest pushes the debt over the credit limit), then Congress has ample power to do so. Others may speak to whether the benefits of availability of high cost consumer credit outweigh its costs, but it seems to make more sense to address that issue directly rather than by amendments to the Bankruptcy Code, especially where those amendments are unlikely to produce the desired change in conduct.

Similarly, to the extent that the mechanical means test is flawed, that problem should be addressed directly. S. 257 in effect creates a lottery in which some debtors receive an exemption from the mechanical means test but others do not, simply because of the existence of a single, perhaps small, debt arising from a high cost consumer credit transaction. All creditors lose whatever benefit they might have gotten from the mechanical means test, because one creditor charged a high rate. If the mechanical means test is so flawed that no creditors should receive any benefit from it, then Congress should act directly to change it; but if it serves a beneficial purpose, why should one creditor be able to deprive all the other creditors of that benefit?

I would also note that high interest rates sometimes come with special benefits. A high interest rate credit card might have no annual fee, and it might entitle the card holder to higher "rewards" (frequent flyer miles or cash back) than other cards. Such benefits may be particularly important to card users who seldom or never carry a balance on the card. To the extent that

Congress believes high credit card interest rates should be penalized in some way, the triggering level should be set high enough to allow such cards to be offered.

II

On a technical level, there appear to be questions about how S. 257 would operate. The one page description of the bill states that "An 'applicable interest rate' under the CCFA includes an annualized calculation of all penalty fees and charges. This will prevent lenders from 'innovating around' the legislation by shifting from high interest to high fees." But the reference in section 2(a)(2) of the bill to the "applicable annual percentage rate" does not seem to include fees in the calculation unless they are "incurred in connection with the extension of such credit." The "extension of credit" occurs when the credit is used, typically to make a credit card purchase. Where that use of the credit does not trigger the fee, it is not at all clear that the fee would be included in the rate under the language of the bill. A late fee (or even an overlimit fee caused by accrual of interest) does not seem to be "incurred in connection with the extension of ... credit" but rather incurred in connection with the failure to repay the debt as promised.

In addition, it is not clear what the purpose is of the phrase "for the purpose of distribution under this title" in section 2(b) of the bill. The "claim arising from a high cost consumer credit transaction" is to be disallowed, but apparently only "for the purpose of distribution under this title." Is there some other purpose for which the claim is not disallowed? This language could allow a lien securing such a high cost consumer debt to survive bankruptcy; note that disallowance of a claim has the effect under section 506(d) of voiding any lien securing the claim, but survival of the lien would not result in a distribution being made under the Bankruptcy Code. Thus if the disallowance under the bill is only a limited disallowance--limited so as to affect only the distribution under the Bankruptcy Code--perhaps the claim will not be treated as having been disallowed for purposes of lien survival under section 506(d).

III

Capable and thoughtful witnesses provided testimony during the last session with regard to a very similar bill, S. 3259. Allow me to comment on some of that testimony. Please note that I did not listen to the oral testimony nor have I read any transcript of the oral testimony.

A point made by Judge A. Thomas Small, testifying on behalf of the National Bankruptcy Conference, bears repeating: disallowance of high interest rate claims can work to the detriment of Chapter 13 debtors who fail, as many do, to complete payments under the plan. Although some debtors in such cases can obtain hardship discharges under section 1328(b), many cannot or for one reason or another do not receive a discharge. In such cases, if a high interest rate claim has been disallowed, nothing will have been paid on it during the Chapter 13 case, and when the case is dismissed, the entire high interest rate debt, with very substantial accrued interest and fees, will still be owed. In such a case the debtor would have been better off had some of the payments made under the plan gone to reduce the amount of the high interest rate debt. In my view this negative effect on debtors reinforces the point made above: if Congress decides to in some way prohibit or regulate high interest rate consumer debt, it should do so directly rather than by amending the Bankruptcy Code.

I have great respect for Mr. John Rao, Director of the National Association of Consumer Bankruptcy Attorneys and an attorney with the National Consumer Law Center. I do think, however, that in his written testimony with regard to S. 3259 there was a slip of the pen or misunderstanding that may have influenced the language of S. 257. (Again, I have not read the transcript of his oral testimony, and he may have corrected this point orally.) His written testimony states that under S. 3259 "the means test under section 707(b) would not apply if a consumer's bankruptcy filing 'resulted from a high cost consumer credit transaction.' " That was correct with respect to what I have called the mechanical means test, section 707(b)(2), but nothing in S. 3259 would have kept the court from dismissing the debtor's case on a finding of substantial abuse under section 707(b)(1) if, as provided in section 707(b)(3), the "totality of the circumstances ... of the debtor's financial situation demonstrate[d] abuse." Mr. Rao went on to state that S. 3259's requirement of a showing that high cost consumer debt caused the debtor to file a bankruptcy petition--a showing that if made would prevent the mechanical means test from being used against the debtor--should be eliminated. He stressed that "[e]specially for debtors below the median income, the expense of proving causation might eliminate any benefit gained by an exclusion from the means test." However, debtors below the median income would have no need to make such a showing; the mechanical means test does not apply to them under current law nor would it have applied to them under S. 3259; section 707(b)(7)(A) prohibits use of section 707(b)(2) against a debtor whose income is below the median. Thus, unless I am missing something, it appears that Mr. Rao's argument did not match up with the provisions of S. 3259. I note that in S. 257 there no longer is a requirement of a showing of causation. To the extent that this change from the provisions of S. 3259 was based on Mr. Rao's argument, it should perhaps be reconsidered.

Professor Robert M. Lawless, for whom I have great professional and personal regard, also testified in connection with S. 3259. I would describe the growth of consumer credit somewhat differently from the way he described it in his written testimony. Although it is certainly true that household debt has risen rapidly for more than a decade, most of the rise cannot be attributed to banks taking advantage of the Supreme Court's interpretation of the National Bank Act to issue high interest credit cards. Far more of the increase in household debt was due to mortgage debt than to credit card debt. Since 1997 home mortgage debt has increased by about $6.7 trillion, while other consumer credit has increased by about $1.25 trillion. See Federal Reserve Statistical Release, Flow of Funds Accounts of the United States, Z.1. Release, Table D.3, Debt Outstanding by Sector (showing home mortgage debt rising from $3.7559 trillion in 1997 to $10.4537 trillion in 2008, while consumer credit was rising from $1.3442 trillion to $2.5962 trillion). Thus the increase in home mortgage debt accounted for 84% of the increase in household debt over that period, and home mortgage debt grew at a faster pace than other consumer credit, growing to an amount two and three quarters times as large in 2008 as in 1997, while other consumer credit had not quite doubled. It may be that consumer credit rose too quickly, but it seems that the major problem, as we now know, was home mortgage debt. Of course now one of our difficulties is that consumer purchasing power has weakened, and steps are being taken to revitalize it. It is possible that we need more availability of consumer credit now, not less.

The dramatic increase in home mortgage debt also accounts for an occurrence that rightly worries Professor Lawless: our household debt exceeds our annual national personal income. But

I must disagree with his characterization of that imbalance. He testified that "[e]ven 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." But about 80% of the debt that we would be repaying would be home mortgage debt--and thus payment for housing--and if we nearly paid it off with one year's income, we would nearly own our homes free and clear. Put that way, the situation seems less alarming.

Professor Lawless also refers to the impressive empirical study he and his coauthors recently published (Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors, 82 AM. BANKR. L.J. 349 (2008)). The authors conclude that 800,000 debtors somehow are missing from the bankruptcy system (based on lower bankruptcy filing rates than would have been expected), and that the 2005 bankruptcy amendments did not seem to force out the abusive high income filers. Thus Professor Lawless draws the conclusion in his testimony that the 2005 bankruptcy amendments prevented deserving debtors from obtaining bankruptcy relief by purging "ordinary American families in serious financial distress" from the bankruptcy system. He may be right, though his article notes that misinformation about the continuing availability of bankruptcy relief (misinformation given out in many cases by debt collectors) likely was responsible for at least some of the decrease in filings. I would also note that the unemployment rate actually dropped substantially during the relevant period. The rate for 2002, 2003, and 2004 was 5.8, 6.0 and 5.5, respectively, but it dropped to 5.1% for 2005, and then to 4.6% for 2006 and for 2007. (See bls.gov/cps/cpsaat1.pdf). Lower unemployment during 2006 and 2007 could account for some of the reduction in filings. Of course, now that unemployment has risen substantially, bankruptcy filings are rising as well.

In his testimony, Professor Lawless notes (in line with my testimony above), that the threat of loss of bankruptcy distributions would not lead consumer lenders to reduce their rates because "consumer lenders do not expect large recoveries in bankruptcy and [thus] would continue to charge exorbitant rates" despite the provisions of S. 3259. He makes a very good point that "[p]erhaps the most helpful thing Congress could do is to take measures that would lower the costs of filing bankruptcy." I also heartily endorse his call for an amendment to "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," and that similar provision should be made in section 707(b).

Finally, I must note that his testimony urges a step that I think would be a mistake, allowing debtors in chapter 13 cases to strip down their home mortgages to the court-determined value of their homes. He argues that "[t]he 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." But many chapter 13 plans fail, and a promise to pay is no guarantee of receipt of payment. In fact, the mortgage lender would be stuck with the risk of further loss in the home's value, but without any realistic prospect of gaining from future appreciation. Professor Lawless also argues, as many others have, that allowing strip down of home mortgages would just treat them the same in chapter 13 as vacation homes and investment properties are already treated in chapter 13. As I pointed out when I testified last year, substantial first mortgages on vacation homes or investment real property cannot as a practical matter be stripped down in chapter 13 cases under current law, because the stripped down mortgage would have to be paid off with interest over no more than five years, which would make the payments far too high. See Bankruptcy Code section 1325(a)(5)(B)(ii) (and 1322(d), limiting duration of plan to five years); In re Enewally, 368 F.3d 1165 (9th Cir.), cert. denied, 543 U.S. 1021 (2004); Congressional Oversight Panel, Foreclosure Crisis: Working Toward a Solution (March Oversight Report), page 54, cop.senate.gov/documents/cop-030609-report.pdf. The Congressional Oversight Panel admits that the kind of strip down being proposed for home mortgages in chapter 13 cannot be done under current law with respect to vacation homes or other property (though the Panel analogizes to Chapter 11 practice, without noting that in Chapter 11 creditors have the opportunity to vote on the plan and that undersecured creditors usually can prevent a strip down by making the section 1111(b)(2) election):

"The type of bankruptcy modifications proposed for mortgages on principal residences differs from the debt restructurings that are currently permitted for vacation homes or rental property, if they are modified in Chapter 13. In Chapter 13, all debts, including the reduced principal amount, must be repaid within the three-to-five years duration of the bankruptcy plan. In Chapter 11, by comparison, vacation homes, rental property and mortgages on all business property can be stretched over decades. The proposed bankruptcy modification would permit the modified loan on the principal residence to be held to maturity and repaid over as much as thirty years. The length of the anticipated repayment period in the proposed bankruptcy modification would be more like the treatment of mortgages on vacation homes, rental property and all business property in Chapter 11."

Again let me say that I very much appreciate the opportunity to testify here today. I would be happy to try to answer any questions the Members may have.