

Testimony of

# **The Honorable Rosemary Gambardella**

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WRITTEN TESTIMONY OF HONORABLE ROSEMARY GAMBARDELLA United States  
Bankruptcy Court for the District of New Jersey  
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Subcommittee on Administrative Oversight and the Courts

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Chairman Whitehouse, thank you for inviting me to speak before this Subcommittee on the important subject of abusive credit card practices and their relationship to bankruptcy.

My testimony will address the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCA"); the sweeping changes it made to the Bankruptcy System, including its goals, the restrictions it placed on a consumer debtor's ability to file for bankruptcy and in particular, its impact given the current economic crisis. In addition, I will also discuss the historical context of bankruptcy as an available form of relief premised upon an assumption of a balanced system, which places debtors and creditors on equal footing. In this context, I will comment on the impact of high cost credit on consumer bankruptcies, the function of the proposed "Consumer Credit Fairness Act" (S.257), and end my testimony by offering some of my own observations and experiences over the last 20 plus years as a bankruptcy judge.<sup>1</sup>

## **I) BAPCA**

BAPCA was implemented on October 17, 2005. With this legislation, Congress "substantially rewrote the Bankruptcy Code" by significantly raising the hurdle for consumers to obtain a discharge of their debts.<sup>2</sup> "The law placed more requirements on bankruptcy filings" and increased filing fees.<sup>3</sup>

A key provision of BAPCA, and perhaps also one of its most controversial provisions, is the "means test," a test requiring an analysis of a bankruptcy petitioner's financial condition to determine whether a Chapter 7, providing for a liquidation of assets in exchange for an immediate discharge of qualifying debt, or Chapter 13, conditioning the discharge of debt upon a three to five year repayment plan, is appropriate. Specifically, the means test "involves taking an average of a debtor's past six months of regular income and subtracting typical expenses for rent, food, insurance, transportation and child support (if applicable)."<sup>4</sup> If there is an amount of disposable income remaining after this calculation, the debtor, under a "presumption of abuse" standard, will be required to commence a Chapter 13. Debtors whose current monthly income (augmented by the current monthly income of a non debtor spouse) is at or below the applicable state median income are within a "safe harbor" and not subject to the means test.

Another of BAPCA's modifications is the requirement that a debtor receive consumer credit counseling from an approved credit counseling provider within 180 days prior to a bankruptcy filing.<sup>6</sup> In addition to this prepetition credit counseling requirement, BAPCPA management. Both the prepetition credit counseling and the postpetition financial management course are mandatory for purposes of seeking relief under the Bankruptcy Code and obtaining a discharge respectively.<sup>7</sup>

Other noteworthy BAPCA provisions place a limitation on the discharge of consumer debt, in particular credit card debt. Under the revised Code, cash advances totaling more than \$825 on a credit card within 70 days of filing are presumed to be non-dischargeable. In addition, charges of luxury goods or services totaling more than \$550.00 on a credit card within 90 days of filing are presumed non-dischargeable.<sup>8</sup>

Moreover, it also extends the statutory proscription on successive or "serial" bankruptcy filings and elongates the period of time that a bankruptcy filing is reflected on a consumer's credit report from 7 to 10 years.<sup>9</sup>

Proponents of BAPCA- among them the banking and credit card industries, car and mortgage loan lenders- advocated that by setting the bar higher for people who could file bankruptcy, the legislation would discourage bankruptcy petitions submitted in an attempt to abuse "the system by deliberately running up [credit card] debt and running away from repayment obligations through the bankruptcy process."<sup>10</sup> Conversely, consumer advocates the Bankruptcy Code are not abusers, but families in serious financial trouble due to illness or divorce. Amending the Bankruptcy Code to make it more difficult to resort to bankruptcy, they contended, would create more stress and suffering for [middle class] families by delaying debt relief."<sup>11</sup>

## II) The Historical Context of Bankruptcy

The current system of bankruptcy law, as it concerns individual bankruptcy filings, can be assessed in terms of three central bankruptcy concepts: liquidation (as embodied by Chapter 7), rehabilitation (symbolized by Chapter 13 and less often Chapter 11) and the discharge or forgiveness of debt.<sup>12</sup> These concepts trace their roots directly to the Bible.<sup>13</sup> For instance, the Bible "makes it clear that people are generally expected to pay their debts. Leviticus 25:39."<sup>14</sup> "However, this moral and legal obligation to pay just debts must be balanced by such considerations as the need for compassion" for the poor, preservation of the family unit, and the call to cancel debts at periodic intervals. Deuteronomy 15:1-2, 7-10.<sup>15</sup> As these statements reveal, the quest to arrive at the perfect balance between compelling persons to repay their debts since ancient times. It is this healthy tension that has fostered the development of the bankruptcy laws in this country from the early days of bankruptcy referees to the present. It is also the pendulum responsible for BAPCA as well as the Consumer Credit Protection Act, the very Act which is the subject of this Senate Subcommittee's Hearing.

## (II) BAPCA's Impact

A) Increase in Bankruptcy Filings. The implementation of BAPCA on October 17, 2005 followed a spike in bankruptcy filings approaching 2 million. Post BAPCPA, filings then fell to a low of 617,000 cases in 2006.<sup>16</sup> Overall, in 2007, the proportion of debtors filing a Chapter 7 petition accounted for 60%, of all consumer cases, down from more than 71 % in 2003, while Chapter 13 bankruptcies have increased from 29% in 2003 to 39% in 2007.<sup>17</sup> In spite of the

numbers above, which could be interpreted to show BAPCA's effectiveness at staving off bankruptcy filings and preventing perceived abuse, the number of bankruptcy filings began to once again increase in 2007 and to continue to climb upward in 2008. Throughout 2007, more than 850,000 bankruptcy petitions were filed.<sup>18</sup> During 2008, The September 2008 filings are the highest of any 12 month period since the 2005 implementation of BAPCA, when there were 1,112,542 filings in the 12-month period ending September 30, 2006.<sup>20</sup> According to the latest statistics released by the Administrative Office of the United States Courts, Chapter 7 cases accounted for 65% of all cases filed in 2008, compared to 60% in 2007. Chapter 7 cases rose 40% to 679,982. Chapter 13 filings rose 14% to 353,828. During 2008, filings by debtors with predominantly nonbusiness debts, which accounted for 96% of overall filings, rose 30 % to 1,004,342.<sup>21</sup>

#### Impact of high interest credit on Bankruptcy

High cost consumer credit generally comes in the form of credit cards, payday loans, student loans, refund anticipation loans, and subprime mortgages. For the purposes of my testimony, I will focus on the impact of high interest credit cards.

At least one study has found that nearly sixty percent of credit card holders do not pay their bills in full every month.<sup>22</sup> It has been reported that the average interest rate for standard bank credit cards topped 19% in March 2007.<sup>23</sup> The Federal Reserve reported that 46.2 percent \$7,300.00.<sup>24</sup>

In September 2006, the Government Accountability Office (the "GAO") estimated that in 2005 the number of U.S. credit cards issued to consumers exceeded 691 million.<sup>25</sup> The report stated that "[T]he increased use of credit cards has contributed to an expansion in household debt, which grew from \$59 billion in 1980 to roughly \$830 billion by the end of 2005." The report estimated that "the majority-about 70 percent in recent years-of issuer revenues came from interest charges," and estimated penalty fees to account for an additional 10 percent of total issuer revenues.<sup>26</sup> The report concluded that disclosures used to provide information about the costs and terms of using credit cards generally had serious weaknesses which reduced their usefulness.<sup>27</sup> The report stated that in 2005, about 80 percent of active U.S. accounts were assessed interest rates of less than 20 percent-with more than 40 percent having rates of 15 percent or less.<sup>28</sup> The GAO also estimated the average, default interest rates to be approximately 27 percent.<sup>29</sup> the causes of bankruptcy filings. In a 2006 article published in the Stanford Law Review, Professor Warren, together with Teresa A. Sullivan and Professor Jay Lawrence Westbrook argued that "the central characteristic of consumer bankruptcy over two decades has been increasing financial distress marked by rising levels of debt."<sup>30</sup> Using data from the Consumer Bankruptcy Study of 2001 of natural persons filing for Chapter 7 or Chapter 13, Professor Warren and her co-authors state that recent "debtors have substantially larger debt loads than in the previous years."<sup>31</sup> The authors state that "from the early 1980's to the present, Americans' debt burden compared with their disposable income has risen considerably," and note that "at the same time, increased layoffs, high divorce rates, lack of medical insurance, income volatility, and rising housing costs have left families even more vulnerable to bankruptcy."<sup>32</sup> Focusing on credit cards which they describe as the dominant form of lending in recent years, the authors indicate that "interest rates are often ruinous for a family with substantial credit card debt, particularly if the family had missed a beat in making on-time payments," as "the

combination of late fees, over-limit fees, default rates of interest and other charges means that credit cards for families in trouble may easily be running at 24% interest or more."<sup>33</sup> The authors speculate that "changes in the credit industry in making money available to troubled borrowers may have delay bankruptcy, but "the interest payments increased so fast that even a small stumble meant that these borrowers would have to declare bankruptcy or literally never get out of debt."<sup>34</sup> This proposition was supported by a 2007 article written by Professor Robert M. Lawless published in the University of Illinois Law Review.<sup>35</sup>

There have many other law review articles written on the impacts of high interest credit and bankruptcy. In a 2006 article published in the Texas Law Review, Professors Susan Block-Lieb and Edward J. Janger argued that "consumers have increased their debt loads over the past thirty years because lenders have become more skilled at exploiting the biases in their decisionmaking, and not because of the details of consumer bankruptcy law."<sup>36</sup> Professors Brock-Lieb and Janger contend that "consumers will purchase and borrow more than rational consumers would have, and that they will be slower to react to a default situation."<sup>37</sup> Specifically, Professors Brock-Lieb and Janger claim that "the demise of usury law and the development of national credit reporting and credit score systems and mass marketing techniques permitted lenders to create a national market for consumer credit available to even the least credit-worthy members of society-at a price." *Id.* Concerning BAPCPA, Professors Brock-Lieb and Janger argue that it severely limits overleveraged consumer borrowers from obtaining relief consumer limitations."<sup>38</sup>

In a 2008 article published in the Iowa Law Review, Professor Katherine Porter argued that the credit industry seeks to profit from financially distressed and vulnerable consumers by encouraging families to borrow after bankruptcy.<sup>39</sup> Professor Porter hypothesizes that postbankruptcy debtors are marketed credit cards offers, unsecured loans, car loans, second mortgages and live checks since "postbankruptcy families cannot discharge their debts in bankruptcy for a number of years."<sup>40</sup> Professor Porter suggests that "families who do not repay quickly or in full are the most profitable customers for some lending products," as "ultimate repayment may not be necessary for a highly profitable transaction."<sup>41</sup> Concerning BAPCPA, Professor Porter argues that "the credit card industry's lending decisions were not subjected to the same scrutiny as debtors' borrowing decisions," and that lenders were not "held to the same moral standard as debtors for evaluating the appropriateness of their financial practices." *Id.* at 1372.

In a 2006 article published in the Tennessee Law Review, Professor Rashmi Dyal-Chand argued that credit card borrowers do not understand the implications of borrowing on a high interest credit card, and that "borrowers rarely read the fine print in advertisements and contracts they receive, relying on the statements in bright bold letters to make decisions about which card

#### Analysis of Current Bill

The proposed Consumer Credit Fairness Act would disallow in bankruptcy any claims arising from a "high cost consumer credit transaction" defined as a "an extension of credit by a 'creditor (as defined in section 103 of the Truth in Lending Act (15 U.S.C. 1602(f))), resulting in a consumer debt that has an applicable interest rate (as determined in accordance with section 107(a) of the Truth in Lending Act (15 U.S.C. 1606(a)), and including costs and fees incurred in connection with the extension of such credit) that exceeds at any time while the credit is

outstanding, the lesser of--the sum of 15 percent and the yield on the United States Treasury securities having a 30-year period of maturity; or 36 percent." Currently, under that standard, the CCFA would apply to any interest rate higher than 18.5 percent. Additionally, the proposed Consumer Credit Fairness Act would excludes debtors with any debts arising from a "high cost consumer credit transaction" from the means test.

The articulated purpose of the 2005 BAPCA amendments to the Bankruptcy Code was to inject balance into the adjudication of debtor-creditor rights. In fact, the myriad requirements placed on consumer debtors, including the use of means-testing, may have created substantial burdens on consumer debtors without the desired result - increased repayment of debt. It is clear from experience that debtors' use of credit cards as a "family lifeline" to cover basic living expenses such as food, sustenance, utilities, health care, and tuition is a trend that is seen throughout the cases that come before our courts. The proverbial "robbing Peter to pay Paul" has bankruptcy of a specific category of high cost loans contemplated by this bill may act as a disincentive to such practices. As well, the specter of disallowance of claims in bankruptcy may encourage out-of-court settlements. The disallowance of the claims, as opposed to subordination of the claims, would also result in a greater recovery to other unsecured creditors with valid and bona fide claims. In my experience on the bankruptcy bench it must be emphasized here that bankruptcy relief is largely utilized by individuals as a last resort for legitimate, non-abusive purposes. The fresh start afforded by bankruptcy to individuals suffering under enormous debt loads, particularly in the current economic climate, is a laudable goal. The disallowance of certain high-cost credit claims will, in certain instances, substantially decrease the debt burden on debtors, increasing the prospects for successful reorganization and/or repayments through orderly liquidation to bona fide creditors.

While many debtors and their families' income fall below the applicable respective state median income levels and escape the means test, the elimination of means-testing for this category of consumer debtors would make the pathway to Chapter 7 relief more readily available. Again, to the extent that repayment is the goal - such a remedy may be an additional disincentive for predatory lending practices.

It is worth noting that while the remedies in the legislation are limited to bankruptcy filings, this involves the much broader issue of predatory lending practices that reach far beyond the bankruptcy arena.

In closing, thank you for the opportunity to testify before this Committee on these important issues. I stand ready to provide any additional information on these points to the Subcommittees that may be of assistance.

I wish to acknowledge the assistance of my law clerks, Adam Glanzman, Esq. and Anthony E. Hope, Esq., Jeanne Naughton, Esq., Staff Attorney for the United States Bankruptcy Court for the District of New Jersey, my Judicial Assistant Rosemary Paul and Jennifer A. Bosset, my judicial intern in the preparation of this written testimony.

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3LaToya Irby, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. March 18, 2009. About.Com. <http://credit.com/od.consumercreditlaws.a.bapcpa2005.htm>.

4Woolsey, *supra*.

5Ibid.

6Irby, *supra*.

7Credit Woolsey, *supra*.

8<http://www.davelima.com/Blog/bid/5586/It-s-Alive-Chapter-7-Bankruptcy-After-BAPCPA>

9Connie Prater, Bankruptcies creeping upwards as economy sours. March 18, 2009. <http://www.creditcards.com/credit-card-news/bankruptcy-law-third> anniversary.

10Ibid. See also Woolsey, *supra*.

11Ibid.

12 David A Skeel, Jr., *Debt's Dominion, a History of Bankruptcy Law in America*. Princeton University Press, Princeton, U.S.A. (2001) at 7.

13See Discharge Hearing conducted by the Hon. Vincent J. Commisa, Chief Judge, United States Bankruptcy Court for the District of New Jersey (June 13, 1985). (Exhibit attached).

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15Ibid.

16Prater, *supra*.

17Ibid.

18Ibid.

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20Ibid.

21Ibid.

22Michael S. Barr, An Inclusive Progressive National Savings and Financial Services Policy, 1 Harv. L. & Pol'y Rev.161, 174 (2007).

23Credit Card Statistics by Mark Brinker, updated February 2009. <http://www.hoffmanbrinker.com/credit-card-debt-statistics.html>

24 "Changes in the U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," dated February 2009 at A38, A45.

25See Report to the Ranking Minority Member, Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate entitled Increased Complexity in Rates and Fees Heightens Need for More Effective Disclosures to Consumers.

26Id. at 8.

27Id. at 33.

28Id. at 5.

29Id. at 70.

30Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings, 59 Stan. L. Rev. 213, 218 (2006).

31Id. at 228. 32Id. at 249. 33Id. at 232.

34Id. at 251.

35See Robert M. Lawless, The Paradox of Consumer Credit, 2007 U. Ill. L. Rev. 348, 367-368.

36See Susan Brock-Lieb & Edward J Janger, The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided Reform of Bankruptcy Law, 84 Tex. L. Rev. 1481, 1563 (2006).

37Id. at 1565.

38Id.

39See Katherine M. Porter, Bankruptcy Profits: the Credit Industry's Business Model for Postbankruptcy Lending, 93 IALR 1369 (2008).

40Id. at 1374, 1420.

41Id. at 1418.

42See Rashmi Dyal-Chand, From Status to Contract: Evolving Paradigms for Regulating Consumer Credit, 73 TNLR 303, 338-339 (2006).