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Bankruptcy Relief and Natural Disaster Victims

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Summary

In the wake of Hurricane Katrina, many have questioned whether implementing the new procedures of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), P.L. 109-8, scheduled to go into effect on October 17, 2005, should be delayed.

This report considers whether bankruptcy law in general, and the BAPCPA in particular, may present unique challenges to financial recovery for those whose life, livelihood, and/or home have been damaged or destroyed.

To some extent, the new goals of the BAPCPA, which is designed to restore personal responsibility to individual's financial affairs and reduce the number of chapter 7 filings, may be at odds with the goals of those who want to assist Katrina victims through a speedy financial rehabilitation procedure under chapter 7 of the U.S. Bankruptcy Code.

The BAPCPA is an extremely lengthy, complicated, and technical overhaul of bankruptcy practice. Many of its provisions will undoubtedly be of assistance to debtors, while others are more problematic. This report reviews just a few elements of the new law in areas such as burden of proof, debt forgiveness, flexibility, transaction costs, and small business reorganization and considers their implications for Katrina victims. It concludes that it may be impossible to predict how the implementation of a new bankruptcy system will impact Katrina victims, whose specific needs in a bankruptcy context are not yet known.

To date three bills, H.R. 3662, H.R. 3697 and S. 1647, have been introduced which address the issue of bankruptcy relief for Katrina victims. These bills include provisions to push back the effective date for implementation of the BAPCPA, and to make substantive changes to the Bankruptcy Code for the benefit of disaster victims. This report will be updated as events warrant.

Contents

Background	1
Defining Debtor and Creditor Needs	2
The Goals of the BAPCPA	3
Burden of Proof	4
Limitations on Debt Forgiveness	4
The New Law: How Flexible Is It?	5
BAPCPA Increases Transaction Costs	6
Small Business Reorganization	7
Legislative Response	8
Conclusion	8

Bankruptcy Relief and Natural Disaster Victims

In the wake of Hurricane Katrina, many have questioned whether implementing the new procedures of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), P.L. 109-8, scheduled to go into effect on October 17, 2005, should be delayed. Several bills have been introduced which address this issue.

This report considers whether bankruptcy law in general, and the new law in particular, may present unique challenges to financial recovery for those whose life, livelihood, and/or home have been damaged or destroyed.

Background. Chapter 7 of the U.S. Bankruptcy Code governs liquidation of individual and business assets and is used most frequently by individuals. Liquidation involves marshaling the debtor's assets as of the bankruptcy filing, reducing them to cash, distributing the proceeds to creditors, and forgiving, i.e., discharging the debtor from most debts that predate the filing. A bankruptcy reorganization under chapter 13 allows a debtor to discharge indebtedness by using future income to pay past debt. In return, the debtor may be able to retain some assets that would have to be surrendered in liquidation.

The U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, has historically and continues to make limited distinctions between types of debtors by occupation, (i.e., wage earners, farmers, family farmers, fishermen, railroads, commodity brokers, etc.). While there are many different provisions addressing various debtor and creditor groups, there are far fewer instances of chapters or subchapters tailored to a discrete debtor group's needs.¹ In addition to providing different procedures for reorganizing specified debtor groups, some potential debtors, specified businesses such as domestic insurance companies and banks, are not permitted to file in bankruptcy.² Business entities that are not permitted to file generally have other regulatory regimes to deal with their insolvency.

Despite its complexity, the Code establishes general rules for the treatment of a debtor and his or her indebtedness. In terms of debt, the primary distinction for bankruptcy purposes is between secured and unsecured debt. Secured indebtedness, such as home mortgages and automobile liens, are treated differently under the U.S.

¹ Chapter 9 governs the reorganization of a municipality, when it is permitted to do so by the state. Chapter 12 is designed to establish an expeditious and streamlined reorganization process for family farmers and fisherman. Under chapter 11 which governs business reorganization, there are subchapters addressing railroads, stockbrokers, commodity brokers and clearing banks.

² 11 U.S.C. § 109.

Bankruptcy Code and commercial law in general; they cannot be fully discharged. Unsecured claims, which are essentially contractual obligations to repay without a pledge of collateral, may be discharged. Chapter 7 is utilized by debtors to discharge unsecured debts such as credit card debts.

Defining Debtor and Creditor Needs. The ultimate goal of a bankruptcy proceeding is twofold: to give the deserving debtor an economic “fresh start” by forgiving (i.e., discharging) debt, and to maximize the debtor’s estate for the benefit of creditors and distribute it to them equitably. As stated above, bankruptcy law, like the law in general, treats secured and unsecured claims differently. Two major bankruptcy distinctions in the treatment of unsecured debt are that, if there are sufficient assets, some unsecured claims will be paid to creditors before others (which means that some of lower priority may not be paid at all),³ and some may not be discharged in bankruptcy (which means that the creditor can continue to attempt to collect from the debtor after the bankruptcy proceeding).⁴

But bankruptcy law does not — and never has — made major substantive or procedural distinctions based on *why* the debtor files. Although there have been many studies of the reasons that people file in bankruptcy, most, of necessity, extrapolate from limited data. Nonetheless, regardless of the integrity of such studies, it may not be clear how a general survey of bankruptcy schedules and filings and debtor interviews will account for the aftermath of catastrophic, though geographically limited natural disasters. An informal review by a bankruptcy law professor suggests that there may be a strong statistical link between hurricanes and bankruptcy filings.⁵ Yet accepting a common sense assumption that economic catastrophe results in more bankruptcy filings still does not teach exactly what kind of bankruptcy law changes may be desirable to accommodate the affected population. For example, during debate over the BAPCPA, researchers released a report suggesting that many individuals file in bankruptcy to deal with unmanageable medical expenses.⁶ Some argued that a debtor who has incurred high medical expenses should receive different treatment under the bankruptcy law. But pre- and post-BAPCPA bankruptcy law remains neutral with respect to why the debtor is filing. The law sets forth a program that specifies the manner and extent to which debts are to be paid or discharged.

³ 11 U.S.C. § 507. The majority of chapter 7 filings are “no asset” filings in which no creditor receives disbursement of funds.

⁴ 11 U.S.C. § 523.

⁵ Peter Gosselin, *New Bankruptcy Law Could Exact a Toll on Storm Victims: Unless changes are made, some say the overhaul due to take effect could make it tougher for Gulf Coast residents to recover*, L.A. TIMES, Sept. 7, 2005 at A17. In the article, Prof. Robert Lawless indicates that bankruptcy filings after 18 major storms that each caused over \$1 billion dollars in damage rose more than 1 ½ times the national average within areas affected for at least one to three years afterward.

⁶ For more background on this issue, see CRS Report RS22096, *Treatment of Health Care Expenses under the Bankruptcy Abuse Prevention and Consumer Protection Act*, by Robin Jeweler.

Indeed, there are many challenges to determining what particular needs may or may not be unique to hurricane victims. Some assume that filings will occur shortly after the crisis, when homes are destroyed and jobs lost. Others believe that filings will peak after several years, when individuals try to rebuild their lives and encounter obstacles such as lower paying jobs or chronic medical problems. Many victims may not return to their homes in the stricken areas, but will start their lives over in new locales. And for many others, the obstacle may not be a complete lack of resources. Some individuals will have adequate insurance to cover their property losses and jobs to return to. But the length and scope of the disruption to their lives may present their own unique financial hardships.

Tailoring bankruptcy law to the underlying causes of bankruptcy is perhaps not achievable. Because individual finances are so fact-specific, bankruptcy law deals only with process. But historically, in times in financial crisis like the Depression, economic relief was facilitated by legislation permitting some manner of bankruptcy filings.⁷ And under the 1978 law, financial rehabilitation of individuals was effected by access to chapters 7 and 13.

The Goals of the BAPCPA. Under the Bankruptcy Reform Act of 1978,⁸ Congress created a streamlined, expeditious system for individuals to file under chapter 7. Over the years, millions did. The high number of individuals filing in bankruptcy led Congress to perceive that bankruptcy relief was too easy to obtain and that debtors were abusing the process.⁹ The amendments effected by the BAPCPA are designed to reverse that trend. The law implements rules and procedures which are designed to reverse the perceived ease of filing, to require that bankruptcy relief be conditioned upon debtors dedicating a portion of their post-bankruptcy income to pay off their pre-bankruptcy debts, and to limit the amount of debt that may be forgiven. However, the approach the new law takes is without precedent in the administration of the bankruptcy laws of the United States. Because there is no empirical or experiential data to evaluate this new approach to debt repayment, many have questioned whether it is flexible enough to accommodate the situations in which victims of Hurricane Katrina, indeed all natural disasters, may find themselves. Some believe that it may be desirable to adapt many pre-existing and new substantive and procedural requirements to disaster victims' identifiable needs.

The BAPCPA is an extremely lengthy, complicated, and technical overhaul of bankruptcy practice. Many of its provisions will undoubtedly be of assistance to debtors, such as the clarification of the treatment of retirements funds in Individual Retirement Accounts, or the treatment of money in educational savings accounts, which are protected from creditors. Others may pose challenges. A sampling of these issues and their implications for Katrina victims are considered below.

⁷ Virtually all of the early bankruptcy laws of the United States, enacted on a temporary basis, were in response to economic hardship. *See, e.g.*, 2 Stat. 19 (April 4, 1800); 5 Stat. 440 (August 19, 1841); 14 Stat. 517 (March 2, 1867).

⁸ P.L. 98-598, as amended.

⁹ *See* H.Rept. 109-31, Part I, 109th Cong., 1st Sess. 2 (2005), *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*.

Burden of Proof. In furtherance of the policy of making chapter 7 filings more difficult to obtain, the BAPCPA imposes a significantly higher burden of legal and evidentiary proof for prospective debtors in numerous contexts. A basic example of this shift is the amendment of 11 U.S.C. 707 governing dismissal of a chapter 7 case. Under the law scheduled to expire on October 17, 2005, when a bankruptcy judge considers whether to dismiss a chapter 7 case for abuse, “[t]here shall be a presumption in favor of granting the relief requested by the debtor.” That presumption is omitted in the BAPCPA and is replaced by the presumption, embodied in the means test, that a debtor who can theoretically pay \$100 a month towards unsecured debts is abusing chapter 7 and must reorganize under chapter 13.

Burdens of proof and legal presumptions are important elements of the bankruptcy process. Additional examples of presumptions are those involved in the dischargeability of debt. Use of a credit card to obtain cash advances totaling more than \$750 obtained within 70 days of the bankruptcy filing will be presumed fraudulent and nondischargeable.¹⁰ Likewise, under current law, all student loans are nondischargeable unless a debtor can prove “undue hardship.”¹¹ These presumptions and burdens do not preclude a debtor from receiving bankruptcy relief, but they increase the costs, evidentiary proof necessary, and in many instances, the uncertainty of obtaining debt forgiveness. It is conceivable that standards on presumed abuse, prospective income, and hardship may be difficult to apply to persons unexpectedly displaced for extended periods.

Limitations on Debt Forgiveness. As stated above, bankruptcy deals with two types of debts: secured and unsecured. With respect to unsecured debt, those that cannot be forgiven are nondischargeable. The BAPCPA broadens the categories of nondischargeable debt.¹² The new law also makes major limitations to the debt forgiveness permitted for secured debt. To simplify the process, in order for a debtor to keep possession of collateral, a secured creditor must receive an amount that represents its value. A secured creditor is “secured” only to the value of the collateral, and unsecured for any amount which may be owed but is greater than the collateral’s value.

Valuing collateral, however, is quite complicated. Although the yardstick for the collateral’s value is generally “market” value, determining what that standard actually means has been subject to litigation and judicial interpretation over the years. Different courts have allowed debtors to value collateral (hence, what they owe secured creditors) by such standards as wholesale value, foreclosure value (market value minus the costs to the creditor of foreclosing on the property and reselling it),

¹⁰ 11 U.S.C. § 523(a)(2)(C)(II). This provision is amended by the BAPCPA to be more favorable to creditors than its previous version.

¹¹ See [Sec. of Education] *Spelling: 372,000 students displaced by Katrina* at [<http://www.cnn.com/2005/EDUCATION/09/12/katrina.spellings.ap/index.html>].

¹² For more background on features of the BAPCPA, including nondischargeable debt, see CRS Report RL32765, *The “Bankruptcy Abuse Prevention and Consumer Protection Act of 2005” in the 109th Congress*, by Robin Jeweler.

and replacement value.¹³ The BAPCPA, however, amends the Code by requiring debtors to pay the highest possible amount to secured creditors for property acquired for personal, family, or household use, that is, retail value.¹⁴ In some cases under chapter 13, the debtor will have to pay the purchase price for a car or other item, regardless of its replacement or retail value.¹⁵ Usually, the debtor who repays a secured creditor continues to enjoy use of the collateral. It is not clear how these changes may apply in a case of a debtor whose personal property has been destroyed in whole or in part and whose insurance coverage, if any, may not be soon resolved.

The New Law: How Flexible Is It? The means test is intended to ensure that those who can pay their debts from future income do so. It sets forth a complicated formula to measure income versus expenses. If the formula indicates that the debtor can pay \$100 a month towards unsecured debts the presumption of abuse may still be rebutted by demonstrating “special circumstances.”¹⁶ However, to demonstrate the circumstances (and indeed the destruction wrought by Hurricane Katrina would seem to be a unique circumstance), a debtor “shall be required to itemize each additional expense or adjustment of income” and provide documentation and detailed explanations therefore under oath. Because the statutory language is mandatory, it is unclear to what extent, if any, the court will have discretion to waive that requirement for individuals whose financial records have been destroyed. And it may be problematic to predict future income and expenses for persons uprooted for an undetermined period.

The only category of debtor who is exempted entirely from the rigors of the means test on a basis other than income are disabled veterans whose bankruptcy indebtedness occurs primarily during a period when he or she was on active duty or performing homeland defense activity.¹⁷ Although not explicit, this exemption suggests that a presumption of abuse will apply to all debtors other than specified disabled veterans; veterans may benefit implicitly from the presumption in favor of relief that was omitted by the BAPCPA.

Another provision that may appear to lack flexibility involves pre-bankruptcy credit counseling. In order to file, a debtor must undergo credit counseling within 180 days before filing. Many may argue that such a jurisdictional requirement should not apply when the need for financial relief is the result of a natural disaster, although

¹³ *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997).

¹⁴ 11 U.S.C. § 506(a)(2) (“...replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined”).

¹⁵ *Id.* at § 1325.

¹⁶ 11 U.S.C. § 707(b)(2)(B)(i) provides, in part, “[T]he presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.”

¹⁷ 11 U.S.C. § 707(b)(2)(D). If a debtor and spouse’s combined income is equal to or less than the applicable state’s median income, the means test does not apply at all.

others may feel that it is beneficial regardless of the reason for filing. A debtor may plead “exigent” circumstances that merit a waiver of the counseling requirement. But in no case may the waiver extend beyond 45 days after filing. A complete exemption from the counseling requirement will only exist for those unable to receive counseling because of incapacity, disability or active military duty in a military combat zone.¹⁸

New and complicated domiciliary requirements for bankruptcy exemptions are implemented by the BAPCPA. Although designed to prevent pre-bankruptcy moves by debtors in order to obtain more favorable state homestead exemptions, the system may result in unintended consequences with respect to debtors who are relocated, or who relocate, as a consequence of the hurricane. For example, in certain default situations, a debtor may be required to use federal exemptions in lieu of state exemptions. How this new system of lengthened residency requirements and the dual state/federal system of bankruptcy exemptions will operate is “unclear.”¹⁹

BAPCPA Increases Transaction Costs. The new law increases the transaction cost of bankruptcy for debtors and their attorneys. First, bankruptcy filing fees have been increased to reflect the new responsibilities of the court, the Department of Justice, and trustees under the means test and other provisions of the law.²⁰

Second, and far more importantly, bankruptcy attorneys have new investigatory responsibilities under the law. When BAPCPA becomes effective, a signature by an attorney on a bankruptcy petition will constitute a certification that the attorney has performed a reasonable investigation into the circumstances that gave rise to the filing and has determined that the information provided is well grounded in fact and warranted by existing law.²¹ Attorneys who fail to perform this new responsibility risk sanctions. The duty to verify the accuracy of client information will add time and expense to the task of debtor representation.²²

¹⁸ 11 U.S.C. § 109(h).

¹⁹ “It is not completely clear when federal exemptions would be triggered and that may depend upon whether the state in which the debtor was domiciled for most of the 180 days immediately preceding the 730-day period had specific rules governing its exemptions that prevented the debtor from using that state’s exemptions.” William Houston Brown and Lawrence R. Ahern III, 2005 BANKRUPTCY REFORM LEGISLATION WITH ANALYSIS 70 (Thomson/West 2005)

²⁰ Filing fees for chapter 7 have been raised from \$155 to \$200. 28 U.S.C. § 1930.

²¹ 11 U.S.C. § 707(b)(4)(C).

²² Some critics of the new law believe that there will be a scarcity of attorneys willing to represent debtors. See Patti Bond, *Lawyers wary of bankruptcy rules: Experts say new law will make it more difficult for debtors to obtain counsel*, THE ATLANTA JOURNAL-CONSTITUTION, April 21, 2005 at E1. Bankruptcy attorney malpractice insurance premiums are also predicted to rise. See Dara McLeod, *Malpractice insurers watching impact of bankruptcy law*, KANSAS CITY DAILY RECORD, June 1, 2005.

This task may be complicated by the hurricane disaster scenario. Many debtors may have little to no documentation to support their financial hardship assertions. And, unfortunately, a disaster can be accompanied by those who attempt to take wrongful advantage of it.²³ Therefore, just as the timing and locale of future filings by disaster victims is unknown, so to is the extent to which bankruptcy attorneys will be willing and able to take responsibility for the accuracy of client-provided information.

Third, the adversarial and litigation costs of implementing the new law may generally increase because bankruptcy judges, trustees, attorneys, and professionals have no body of law to guide them in interpreting the new legal requirements. Scholars attempting to explain the new law to practitioners acknowledge that many issues need to be fleshed out. One example is the interaction between chapters 7 and 13. Indeed, the greatest impact of the new law will be not on those who will continue to qualify under the means test as “no asset” chapter 7 debtors, but on those who are subject to mandatory chapter 13 reorganization. Will debtors who do not qualify for chapter 7 be able to complete a chapter 13 reorganization? The question is posed:

There are as many factual scenarios as there are potential debtors, and how the means test plays out in actual practice remains to be seen, but its results clearly do not equate to what may be required of the same debtor in a chapter 13 plan. It is entirely possible that a debtor may be forced into a chapter 13 plan due to failing the means test and then be unable to obtain confirmation of a plan.²⁴

The confluence of a new, stricter bankruptcy regime being implemented simultaneously with a national economic disaster may be unprecedented. It may complicate the task of reconciling new bankruptcy procedures designed to limit access to chapter 7 with the new, and as yet unidentified particularized needs of the hurricane victims.

Small Business Reorganization. Small business entrepreneurs often use credit card loans to fund their business activities. As individuals, they could reorganize under chapter 13 if their indebtedness fell within the chapter’s jurisdictional limits.²⁵ It is increasingly unlikely that they will be able to do so under chapter 13 as amended by the BAPCPA because of the new schedules for determining disposable income.²⁶

Congress has amended chapter 11 dealing with business reorganization to implement special streamlined provisions for small businesses, defined as one with

²³ For example, individuals have been prosecuted for submitting false claims to the Sept. 11 Victims Compensation Fund. *Crime & Justice*, THE WASHINGTON POST, Sept. 14, 1002 at B2.

²⁴ 2005 BANKRUPTCY REFORM LEGISLATION WITH ANALYSIS, *supra* at 36.

²⁵ The limit is currently \$307,675 in unsecured debt and \$922,975 in secured debt. 11 U.S.C. § 109(3).

²⁶ *Id.* at § 1325(b)(2).

indebtedness under \$2,000,000.²⁷ While there are new, more flexible confirmation procedures for small business,²⁸ there are also new, more onerous reporting requirements. A debtor must provide reasonable approximations of projected cash receipts and disbursements and comparisons of actual receipts and disbursements to earlier projections and it must confirm compliance with bankruptcy, tax, and other governmental filing obligations.²⁹ The court must dismiss the case for an unexcused failure to satisfy reporting requirements unless the court finds that absent unusual circumstances, the dismissal is not in the best interests of creditors and the bankruptcy estate.³⁰

Legislative Response. Of the bills introduced to date, H.R. 3662, 109th Cong., 2d Sess. (2005), the “Financial Safeguards for Hurricane Survivors Act of 2005,” would push back the effective date for implementation of the BAPCPA for approximately another two and one-half years. H.R. 3697, 109th Cong., 2d Sess. (2005), the “Hurricane Katrina Bankruptcy Relief and Community Protection Act of 2005,” would add a definition of a “victim of natural disaster” to the Code. It would make many substantive amendments for their benefit, addressing such issues as residential eviction, filing deadlines, conversion, the means test, and small business provisions.³¹ S. 1647, 109th Cong., 2nd Sess. (2005), a companion bill of the same name, would give Katrina victims a grace period during which pre-BAPCPA law would continue to apply to their cases and make many substantive changes on their behalf.³² However, Representative Sensenbrenner, Chairman of the House Judiciary Committee, has announced his intention not to revisit bankruptcy reform.³³

Conclusion. Because the consumer and small business bankruptcy procedures in the BAPCPA are new, their application to disaster victims cannot be predicted with certainty. Proponents of the new approach may feel that, as designed, it will, on an individual case-by-case basis, address the needs of *all* debtors, including victims of natural disasters, by ensuring that those who can afford to pay their debts do so regardless of their reason for filing in bankruptcy. Others may feel that, in the wake of Hurricane Katrina, the timing is not propitious for implementation of a new bankruptcy system, particularly one premised upon the notion that modern easy access to chapter 7 debt forgiveness is largely abused. To the extent that the Congress has rejected the notion of easy access for all to chapter 7, some may advocate a new approach to bankruptcy, namely, crafting different debt relief programs for different debtor groups based upon their reasons for filing and their

²⁷ 11 U.S.C. 101(51C).

²⁸ 11 U.S.C. § 1125.

²⁹ *Id.* at § 308.

³⁰ *Id.* at § 1112(b).

³¹ See 151 CONG. REC. E1803 (daily ed. Sept. 8, 2005)(statement of Rep. Conyers).

³² See *Id.* at S9850 (statement of Sen. Feingold).

³³ Reuters, *U.S. lawmaker won't reopen bankruptcy for Katrina*, Sept. 13, 2005 at [<http://today.reuters.com/news/newsArticleSearch.aspx?storyID=269735+13-Sep-2005+RTRS&srch=sensenbrenner>].

perceived worthiness. In that case, the needs of each group need to be identified with some precision and necessary group-specific safeguards against abuse developed.