Bankruptcy Explained for Non-Bankruptcy Attorneys
By David P. Leibowitz

In these difficult times, bankruptcy has been pervasive. From Chrysler and HartMarx among corporations to those who have filed for individual bankruptcy from Highland Park and Barrington to Antioch and Waukegan, bankruptcy has had a major impact on life in America and in Lake County.

By the time of this publication, more than 20,000 bankruptcy filings will have been made in the Northern District of Illinois. Certainly there will be more bankruptcy cases this year than any year prior to 2005 when a major rush in filings occurred to avoid confronting the changes in bankruptcy law wrought by the so-called Bankruptcy Abuse Prevention Consumer Protection Act ("BAPCPA"). This poorly written and ill-conceived statute neither has prevented abuse nor protected consumers. It has fomented much litigation in courts all through the nation because it is so vague, ambiguous and poorly crafted.

My purpose in this article is to provide the practitioner with some historical perspective as well as some practical background in bankruptcy. This will help you understand why the system works the way it does as well as how it came to be. In addition, you'll have a better idea of how to spot issues and advise your clients when confronted with insolvency – either in their own life or in their dealings with others.

This is intended to be a first in a series. Let me know what interests or concerns you and I'll write about it here.

Origins of Bankruptcy

The Judeo-Christian approach

Surprisingly, in consideration of the origins of the idea of bankruptcy, one has to start with the Bible. According to Scriptures, on the seventh day, the Lord rested. From this idea, the concept of the Sabbath was derived. The number 7 was considered to be important. From this idea, the concept of a sabbatical for the land developed. Scriptures taught that land was to lie fallow during the seventh, or sabbatical year. This "rest" to the land recharged its fertility and was seen to be beneficial. From this, Scriptures taught that if land could be benefited from a sabbatical, people could be as well. Accordingly, it was written that during the seventh year, there would be a suspension of the obligation to pay debt. And during the seventh cycle of seven years – the jubilee year – all debts were to be discharged.

At the time of the destruction of the temple, Judeans traveled to Rome to complain of the actions of their Syrian neighbor – Antiochus (from whose name the village of Antioch is derived). Among other things, the Judeans brought with them their idea of sabbaticals from debt. And the Romans appeared to have adopted them. In

ancient Rome, an artisan would signify the failure of his business and inability to pay debts by breaking his bench and leaving it outside his door. The Latin term for this act of "breaking one's bench" was *banca rotta* meaning "broken bench."

The system of allowing a debtor to discharge his debts and get a fresh start was deemed to be socially beneficial because it prevented creditors from oppressing debtors. The natural consequence of excessive oppression of debtors by creditors literally could be the enslavement of the debtors by the creditors. Such a result was not permitted by Scriptures in the Judeo-Christian tradition, which probably derived from traditions in places in other parts of the world as well.

The Anglo-Saxon approach

A much different approach to debt developed in the Anglo-Saxon tradition. There, a debtor who did not or could not pay his debt was treated more or less as a social pariah at best and as a criminal at worst. Debtors' prisons were developed. Debtors could be displayed in public squares in stocks. Debtors could buy their way out of prison by becoming indentured servants to their creditors and working for them for a period of years.

Those who left England to form the Colonies did not particularly like the Anglo-Saxon approach to debt. Their religious tendencies led them to find the Judeo-Christian approach to be more to their liking. Indeed, the colony of Georgia, founded by James Oglethorpe was in direct response to horrible conditions in England experienced by those who were unfortunately unable to pay their debts.

In 1728, Oglethorpe's friend, Robert Castell, was jailed in London for failure to pay his debt. Unable to pay for room and board for the prison staff, he was jailed with another prisoner suffering from smallpox. Castell died, solely because he was unable to pay his civil debts. Oglethorpe was alarmed that so many Englishmen faced jail for no other reason than indebtedness.

American Developments

In light of this history, it is perhaps no surprise that the United States Constitution is one of the few in the world which specifically addressed bankruptcy. Article I, section 8, clause 4 of the Constitution specifically grants to Congress the right:

> To establish a uniform rule of naturalization, and uniform laws on the subject of bankruptcies throughout the United States

Three points are interesting here. First, bankruptcy was considered to be of equal national importance as immigration and naturalization. Second, laws on both subjects were to be federal and not state-by-state. Third, bankruptcy was considered to of constitutional importance.

Bankruptcy law developed in the United States in fits and starts. And as will be seen, it has continued to reflect the economic struggle between debtors and creditors. Moreover, it reflects a struggle to compromise and harmonize the rehabilitative Judeo-Christian-Roman approach with the punitive, uncompromising Anglo-Saxon approach to debt.

BAPCPA reflects that continuing struggle between debtors and creditors. Let's see why.

Genesis of BAPCPA

The leading spokesman for proponents of BAPCPA has been Professor Todd Zywicki. Professor Zywicki is a professor of law at George Mason University, in suburban Virginia. There, he is funded by the Mercatus Center, a market oriented anti-regulatory think-tank which is largely funded by Koch Industries Inc., an oil and gas company which is a substantial contributor to the Republican Party. Professor Zywicki famously testified that he thought that BAPCPA was perfect as written and that not a single word in the proposed statute needed to be changed. Banks and other financial institutions spent almost $100 million in lobbying efforts and contributions over the years to get this legislation enacted.

BAPCPA was the subject of many battles in Congress before it passed. For years, the so-called "Schumer Amendment" seeking to make damages arising from attacks on abortion clinics to be non-dischargeable was a stumbling block. However, support for the bill was garnered from many Democratic senators who were pleased that "domestic support obligations" were to be established as the highest priority after secured creditors under BAPCPA. The junior senator from New York, Hillary Clinton, was a champion of this provision. It should be noted that New York is also home to many of the banks who felt that BAPCPA would be helpful to them.

The leading Senate proponent of BAPCPA was Senator Grassley of Iowa. In 2006, he stated "the big story is, Congress wanted to suppress the number of filings, and they have succeeded mightily." It seems that the suppression of filings was only a temporary phenomenon. Lately, he's been the fellow who suggested that executives of AIG should be so ashamed of their actions that they should either quit or commit suicide.

In any event, BAPCPA was passed in 2005 with an effective date of October, 2005. So many people feared the consequences of BAPCPA that a major rush to file bankruptcy cases prior to the effective date of the new law ensued. More people filed bankruptcy cases in 2005 than in any other year in United States history.

The flavors of bankruptcy

The big idea of bankruptcy is that an honest debtor should get a fresh start. The "social contract" of bankruptcy is that if you are willing to give up your non-exempt

property to a trustee for the benefit of creditors, you should be able to get a fresh start, provided that you are an honest debtor. This is the general idea of "straight bankruptcy" or chapter 7.

Involuntary servitude for debtors was frowned upon. However, if a debtor had assets to protect, like a car or substantial equity in a house, chapter 13 was an option. Under chapter 13, one could work for 3 to 5 years and devote one's disposable income to a plan. This is the so-called "wage-earner plan." If the disposable income was more than the creditors would get in liquidation, it was a win-win situation. Debtors could keep their property and creditors would get paid more than in a straight bankruptcy.

Chapter 13 was generally elective. Even a person who made a moderate living, like a senior states attorney, for example, could file a chapter 7 case as long as he or she had no non-exempt assets. Since up to $30,000 of homestead is exempt in Illinois as is cash value of life insurance and 100% of the value of an IRA, along with $2400 equity in a car, all of one's clothing and up to $4000 in other property, many people were eligible for chapter 7 even though they might have had good paying jobs.

"Bankruptcy Abuse"

The big idea in BAPCPA is that people abuse bankruptcy. In fact, the big idea in BAPCPA is that people who make more than the median income are presumed to be abusing bankruptcy by filing. Now, unlike prior to 2005, a person who makes more than the median income is presumed to be abusing the bankruptcy system if he or she seeks to file a chapter 7 case. The debtor can "overcome the presumption" by completing a comprehensive "Means Test Form" based on Section 707(b)(2) of the Bankruptcy Code. The "means test" has turned out to be complex, ambiguous and spawned a lot of litigation around the country. Even our 11 bankruptcy judges in the Northern District of Illinois have not come to a uniform analysis as to many of the arcane points contained in this statute. In general, however, the debtor is to calculate the average income received during the six months prior to bankruptcy. From this, the debtor is to deduct monthly contracted payments for secured debt, taxes and various allowances in accordance with a mechanical formula derived from Internal Revenue Manuals. Certain other expenses are allowed to a limited extent. If the debtor has sufficient current monthly income after expenses with which he could pay a prescribed amount under a chapter 13 plan, he must proceed in chapter 13 – otherwise, his case would be presumed abusive and be subject to dismissal.

So now, people who make more than the median income are presumed to be abusing the bankruptcy system unless they can overcome the presumption of abuse. And even if they do overcome the presumption of abuse they still must contend with Section 707(b)(3) of the Bankruptcy Code. This section states that even a debtor who overcomes the presumption of abuse might still suffer dismissal of her bankruptcy case in chapter 7 if such a filing constitutes an abuse taking into account the totality of circumstances. In general, this means that a debtor with "projected monthly disposable income" must file a

chapter 13 case even if they overcome the presumption of abuse. This is a controversial area but it does reflect the position of the United States Trustee as well as many courts.

Bankruptcy Reform and Unintended Consequences

The proponents of BAPCPA thought it would reduce abuse. It turns out that there was a lot less "abuse" than there was thought to have been. They also thought it would result in increased collections of credit card debt outside of bankruptcy. And it did. It delays bankruptcy because of "credit counseling" requirements. It avoids discharge in come cases owing to post-petition "financial management course" requirements. So BAPCPA did achieve its goal of greater credit card realizations. However, it did so at the expenses of debtors' ability to make mortgage payments. Many scholars, including researchers at the New York Federal Reserve believe that BAPCPA backfired and was one of the precipitating causes of the mortgage meltdown and economic crisis we are experiencing today. Donald Morgan, stated that BAPCPA was a major reason for the foreclosure crisis and the falling house prices in the U.S. Before BAPCPA, consumers who over extended themselves could file bankruptcy to free up income to pay the mortgage.

Under the current law, if they are unable to file Chapter 7, they are denied that escape route and are forced to continue paying unsecured creditors making it much more difficult to continue paying the mortgage.

Tension between the Anglo-Saxon model and the Judeo-Christian-Roman model

As can be seen, our present system of bankruptcy reflects the tension and balance between two conflicting ideas as to how society should deal with debt. The Judeo-Christian-Roman model is now embodied in chapter 7, a rehabilitative procedure whereby the honest debtor gets a fast and fresh start. The Anglo Saxon model is now embodied in chapter 13. No longer is chapter 13 a semi-voluntary effort whereby the debtor uses sweat equity to keep his property. Now, an above-median earner is deemed to be property himself. The above-median earner must become an indentured servant for the benefit of his creditors for the "applicable commitment period" of 5 years and devote all of his "projected monthly income" to pay up to 100% of his debts off during that period, even if he has no non-exempt property available for creditors at the time of his case.

BAPCPA actually discourages work. A potentially high-income earner is better off if she is unemployed at the time of filing her bankruptcy case. Could Congress really have intended this? One thinks not.

This work is not intended to be a political tract as to the merits of our Bankruptcy Code. Bankruptcy practitioners don't write the law. We work with the law as it is presented to us. We can't help but think, however, that the law is an embodiment of our society's values. And we can't help but wonder exactly what values are embodied in bankruptcy law as codified today.