

# Bankruptcy in Washington

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I recently opened a fortune cookie at a Chinese restaurant. The fortune read LUCK IS COMING YOUR WAY. Please tell me, I asked the waitress, will it be good luck or bad luck? All luck in our restaurant is good luck, she said cheerily.

I could tell she was humoring me. All luck is not good luck. Likewise, all reform is not good reform. This insight has been particularly relevant of late. On April 20, President Bush signed a major reform of the nation's personal bankruptcy law. The new law will take effect in six months. How will it affect ordinary people and the economy?

Currently, people have a choice between two types of bankruptcy: chapter 7 and chapter 13. Filing under chapter 7 cancels your unsecured debts, such as credit card balances, installment loans, medical bills, and so on. In return, you have to give up some of your assets. But you don't give up any of your future income: you get a "fresh start" on life. This makes chapter 7 appealing enough that 70% of people who file for bankruptcy choose it.

If you choose to file a chapter 13 bankruptcy, none of your debts are forgiven at first. Instead, you submit a plan to repay some portion of them over the next three to five years. The plan has to be approved by a judge. If you stick to the plan, then when it ends your remaining unsecured debts are cancelled. Unlike chapter 7, chapter 13 prevents banks from foreclosing on your house for the duration of the plan. This is the main incentive to file under chapter 13. Since chapter 13 filers can switch to chapter 7 if their plan is rejected, they can usually get the judge to agree to favorable repayment plans.

The new reform law creates a means test. If your income during the preceding 6 months was above the median for your area, you cannot file under chapter 7: you must file under chapter 13. You are also forced to accept a repayment plan that leaves only a trickle of income to pay for living expenses.

Many people do not realize that when small businesses go under, they often use the personal bankruptcy laws. This can be because they are sole proprietorships, or because banks require the officers of small companies to sign personally for loans. So an unintended consequence of getting tough on debtors will be to discourage risk-taking and innovation by small businesses. This may slow our economic growth and make the U.S. less competitive vis-à-vis other countries.

The new law will also encourage some households to "game the system". By reducing their incomes in the six months before filing for bankruptcy, they can qualify for a more favorable chapter 7 bankruptcy. For example, household members might quit their jobs. This type of wasteful abuse would be hard to detect.

Perhaps the worse provision of the new law is to force people to undergo credit counseling before declaring bankruptcy. Any guess which industry lobbied for this provision? On its web site, the Federal Trade Commission warns consumers about credit counseling services that charge high hidden fees and steal their clients' debt payments. Instead of offering education, these services push dubious "debt management plans" that mainly benefit the counseling services themselves. The FTC has already forced more than one credit counseling agency out of business. And now Congress and President Bush are forcing debtors to sign up with these agencies at the debtor's expense before they can get any bankruptcy relief. What's next – forcing people to invest their social security funds in time-share villas in the Cayman Islands?

The new law also limits the homestead exemption. Six states, including Iowa, have unlimited homestead exemptions: debtors who file for bankruptcy keep their family home, regardless of its value. This invites abuse, since a debtor can protect her assets by using them to pay down her mortgage shortly before filing for bankruptcy. The new law will limit the exemption to \$125,000 for homes acquired in the past 3 years.

This is a step in the right direction, but it doesn't go far enough. States should not be able to make their own bankruptcy rules. The favorable treatment of certain assets should be abolished. These changes would end the ability of wealthy people to protect their assets by living in certain states and investing in favored assets.

In addition, the right to file for chapter 7 should be returned to owners of small businesses. Bankruptcy stays on your credit record for 10 years. During this period, banks are unwilling to lend to you except at sky-high interest rates. That's enough to ensure that bankruptcy is used only as a last resort.

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