

**BANKRUPTCY REFORM LAW**

# Changes will encourage some to 'game the system'

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.



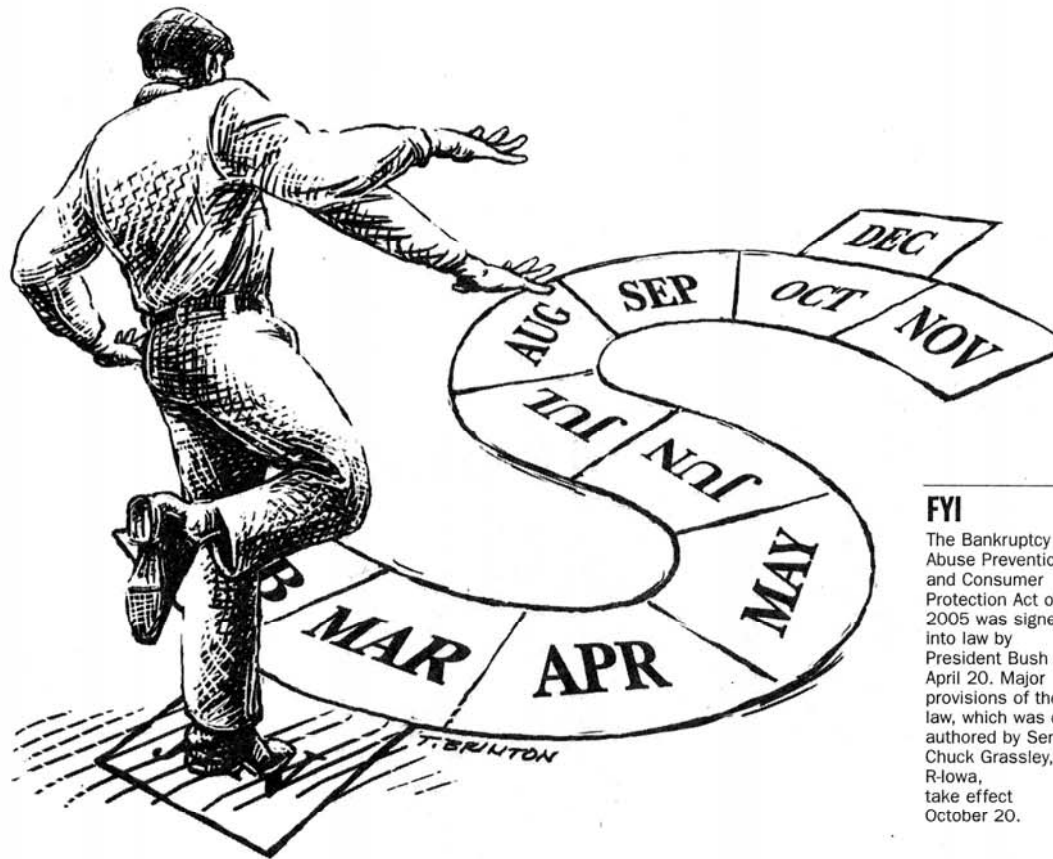
**David Frankel**  
I could tell she was humoring me.

All luck is not good luck. Likewise, all reform is not good reform. This insight is particularly relevant with passage of the new bankruptcy law.

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" in life. This makes Chapter 7 appealing enough that 70 percent 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, your remaining unsecured debts are canceled. 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 six months was above the median for your area, you cannot file under Chapter 7; you must file under chapter 13. You also are forced to accept a repayment plan that leaves only a trickle of income to pay for living expenses.

Many people do not real-

ize 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 United States less competitive vis-a-vis other countries.

The new law also will 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

**FYI**

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was signed into law by President Bush on April 20. Major provisions of the law, which was co-authored by Sen. Chuck Grassley, R-Iowa, take effect October 20.

wasteful abuse would be hard to detect. Instead of offering education, these services push dubious "debt management plans" that mainly benefit the counseling services.

The Federal Trade Commission 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 debtors' 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 three 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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