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September 2005 flooding in Wayland, Massachusetts. *Photographs in this article by Julie Weinstein.*

natural disasters and bankruptcy

A PERSPECTIVE

by Elizabeth Warren
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After the water has receded, after much of the physical devastation is repaired, countless families face a hurricane's most lasting legacy: financial disaster. The car may be gone, the house may be gone, and the credit card bills may have been washed away, but the obligation to pay for all of them remains. The financial stress on families is easy to predict as many people go weeks or even months without a paycheck.

When there is a series of major disruptions like the 2005 hurricane season, hundreds of thousands of middle class families may deplete their savings and turn to credit cards to supplement the aid they receive from charities and the government. Additionally, victims of natural disasters often return home to find that they have lost substantial assets. Insurance may cover some of the damage, but insurance companies' liability is often limited.[1] Every aspect of a family's financial circumstances is exposed to the effects of a natural disaster.

Filing for Bankruptcy

Many disaster victims eventually turn to bankruptcy. (See the sidebar "Personal Bankruptcy Options.") It is possible to analyze bankruptcy filing data following hurricanes of the past 25 years, but limitations in the data make the tools blunt. The filings can be compared only year by year, not quarter by quarter. More important, the long-term data are available only on a state-by-state basis.

To Robert Lawless, a professor at the University of Nevada at Las Vegas, that seemed problematic. A hurricane that hit Houston, for example, might have no effect on families and small businesses in El Paso, Dallas, or Austin. In order to detect a difference statistically, the regional effects would have to be large enough to change the bankruptcy filing numbers for the entire state. As a result, when Lawless decided to analyze the data, he expected to find no statistical correlations. Even if there were important effects following a hurricane, he thought, the rough data would reveal only powerful ones.

In fact, Professor Lawless discovered that in the three years following a hurricane, the growth in bankruptcy filings is about 50 percent higher in states that have suffered a direct hit.[2] In the same time period, the growth in nearby states is about 20 percent higher.

The data show that the location of the disaster also is significant. When the damage occurs in regions where there are many low-cost homes, FEMA payments are lower, and there is a corresponding increase in bankruptcy rates. The highest increase in bankruptcy filings in the past 25 years occurred when Hurricane Elena hit Mississippi in 1985, resulting in a 71.8 percent bankruptcy-filing increase in the following three years.

Changes to the Code

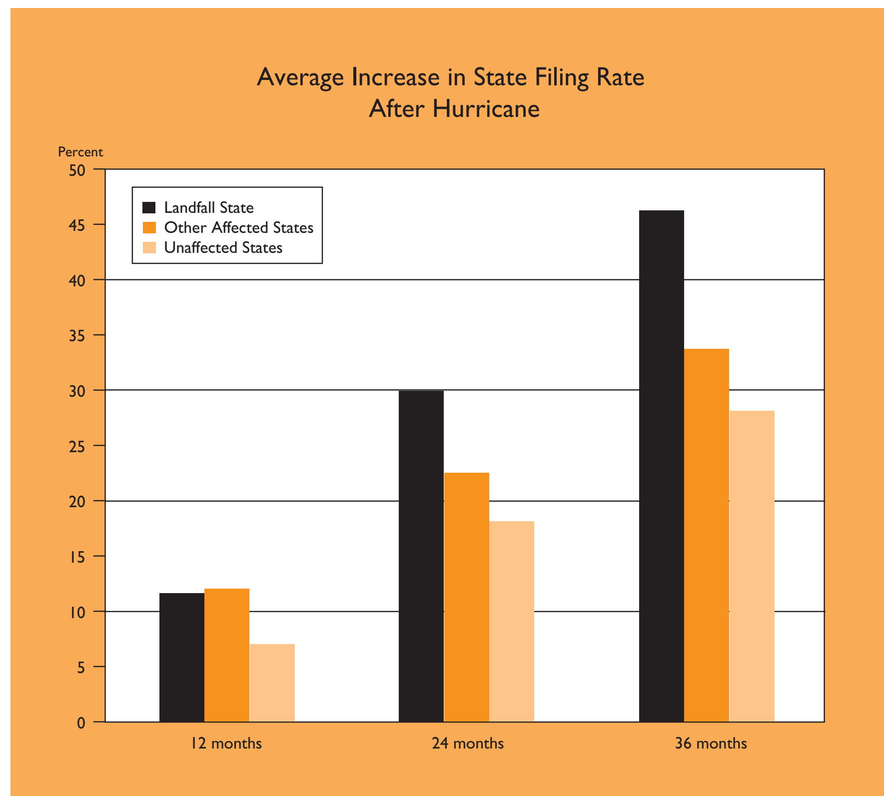
At the same time that victims are digging out from the recent hurricanes, the legal landscape is changing. The 2005 amendments to the Bankruptcy Code went into effect on October 17, about the time the lights were scheduled to go back on in New Orleans. The amendments to the law, more than 400 pages of new procedures, are designed to reduce bankruptcy filings through three principal mechanisms:

- **Paperwork.** The new law requires more documentation of a debtor's financial circumstances, such as six months of paycheck stubs, tax returns, and a full accounting of the monthly budget down to utility payments and insurance bills.[3] The obligations are not limited to those who have high incomes or who have no good reason for filing; they apply across the board.
- **Screening.** Through the application of a complex formula, debtors who have incomes above the median for family size and whose allowable expenses are small enough to leave them with $100 or more of "excess income" each month will be denied access to Chapter 7 and debt liquidation.[4] In addition, no debtor may file for bankruptcy without consulting an approved credit counselor, and no debtor will receive a discharge without attending financial education classes.[5]

• **Reduced Protection.** Tenants who could not be evicted from their apartments under the old laws—so long as they remained current on their post-bankruptcy rent payments—now can be dispossessed.[6] In addition, people filing for bankruptcy will not get relief from as much credit card debt as would have been the case before October 17, 2005.[7]

The new law means that natural-disaster victims, like anyone else, must meet a higher standard if they seek relief through a bankruptcy filing.

Along the Gulf of Mexico right now are other challenges that those planning for disasters elsewhere should note. The legal system in Louisiana was disrupted, so the state bar urged postponement of the effective date of the new laws in the disaster areas.[8] The bar described a "widespread paralysis" of the legal community and difficulty in communicating with clients. Moreover, courts and lawyers scrambling to relocate faced a shortage of office space and adequate infrastructure.



In the three years following a hurricane, the growth in bankruptcy filings is about 50 percent higher in states that have suffered a direct hit.

The new statute has ambiguities that, in time, litigation will clarify, but disaster victims seldom have that kind of time. Additionally, there is uncertainty about whether judges will have the ability to waive some statute requirements for the hurricane victims. Past provisions of the Bankruptcy Code permitted a judge to consider all the facts and circumstances in determining whether a particular bankruptcy petition constituted an "abuse" of the bankruptcy system, but the amended law gives judges less discretion.[9] So, for example, when Mississippi bankruptcy judge Edward Ellington was asked whether debtors whose paperwork was buried in mud could be excused from producing pay stubs and old bills showing regular household expenses, he replied, "I can't grant the waiver on the front end because I just don't have the authority to do it."[10]

In recognition of the difficulties facing victims of natural disasters, on the eve of implementation of the new law, the Justice Department issued special guidelines to the court-appointed officials (trustees) who administer a filer's "bankruptcy estate." The guidelines said trustees would certify that credit counseling was unavailable (thereby waiving the requirement that a debtor be counseled before filing) and that the trustee would not object if the debtor did not produce necessary paperwork, meet statutory deadlines, and so on.[11] Although debtors' attorneys hailed the acknowledgment of the problem, they pointed out that creditors may object whenever debtors violate the law—in short, it is not within the power of the trustees to waive statutory requirements.[12] Also, many debtors' attorneys worry that the coverage is too narrow, leaving out many Mississippi, Alabama, and Texas families that were flooded. It is also unclear how long such waivers will remain in place.

In spite of such challenges, many people are likely to seek bankruptcy relief in the wake of the hurricanes. Some may just put it off. Indeed, Lawless's data show that the largest effects from past hurricanes are felt in the third year after storms hit, suggesting that many families will recover as best they can, and then confront their overall financial condition.

More research on natural disasters' effect on bankruptcy filing needs to be done and new techniques discovered for ferreting out the details. If enough Katrina victims, for example, remain in the places where they have taken refuge, the filing rates may show less relative increase. A diaspora could present a new challenge to studying the effects of natural disasters on bankruptcy filings.

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Personal Bankruptcy Options

Until recently, individuals filing for bankruptcy had considerable leeway in choosing whether to liquidate their debts (under Chapter 7 of the U.S. Bankruptcy Code) or reorganize them and keep paying creditors over a period of three to five years (Chapter 13). Even though they had to give up their property—except for necessities like the tools of their trade, clothing, vehicles up to a certain value, furnishings, appliances, and the like—most people chose Chapter 7.

On October 17, most provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 went into effect. Designed to curb abuses of the U.S. Bankruptcy Code, the act established a needs-based system for qualifying for protection.

The new guidelines include a means test to determine if debtors with annual income above the state median qualify under Chapter 7. Debtors who can pay unsecured creditors such as credit card companies at least $100 per month over five years will be redirected (provided that the amount is sufficient to pay 25 percent of the debt) to Chapter 13. Those able to pay more than $166.66 per month will be assumed to be abusing the system and automatically denied Chapter 7.

The law continues to protect those who face hardships such as serious medical conditions, so long as the extenuating circumstances are supported by documentation.

Calculations of income, expenses, and the like will no longer be based on actual income and expenses but on specified calculations and Internal Revenue Service guidelines for reasonable living expenses "for the support and maintenance of the debtor or the debtor's dependents." Another change is that creditors will be able to recover a larger portion of the property that does not fall into that definition.

The new law was written to require that, before filing, debtors receive credit counseling approved by the court-appointed bankruptcy administrator, or trustee. It also mandates financial management training before debts can be discharged. The court can make exceptions if counseling is not available or if, for example, debtors are incapacitated or on active military duty.

Most of the revisions to the bankruptcy code went into effect on October 17. The law curbs abuses by limiting the possibilities for manipulating the system to protect amassed wealth while charging off accrued debt. It also protects individuals who, because of financial or other hardships, have a genuine need for bankruptcy protection. It does not address abuses by any creditors that use mass marketing and lax underwriting to lure consumers into debt.

The full version of the article "Bankruptcy Reform Legislation," by Lisa Easterwood, appeared in Partners*, the community-development magazine of the Federal Reserve Bank of Atlanta,* www.atl.frb.org.

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Endnotes

[1] Most of those with modest incomes have no flood insurance, which must be paid for separately. FEMA will provide some insurance for some of those who can afford the insurance, but the amount is capped.

2 Robert Lawless, "Bankruptcy Filing Rates after a Major Hurricane," *Nevada Law Journal* (2005).

[3] 11 U.S.C. 707(b)(22).

[4] 11 U.S.C. 707(b)(2)(ii).

[5] 11 U.S.C. 521(b).

[6] 11 U.S.C. 362(b)(2).

[7] Use of a credit card to obtain cash advances totaling more that $750 obtained within 70 days of the bankruptcy filing will be presumed fraudulent and nondischargeable. 11 U.S.C. §523(a)(2)(C)(II). This provision is amended to be more favorable to creditors than its previous version.

[8] Louisiana State Bar Association, et al., *An Open Letter to the United States Congress from Louisiana with Respect to Relief from Certain Provisions of the New Bankruptcy Amendments for Victims of Hurricane Katrina* (September 14, 2005).

[9] The fact that the amendments create specific exceptions for military personnel who are away on active duty or for the disabled suggests that Congress did not believe it had left general discretion with the courts to waive specific requirements. 11 U.S.C. 109(h)(4); 707(b)(2)(D).

[10] Brian Tumulty, "Hurricanes Force More People into Bankruptcy," TheJournalNews.com (September 16, 2005). The new amendments state that a court shall not grant a discharge to any debtor that does not produce his or her tax returns. The specific language of the statute allows no room for exception in extreme circumstances. Section 1228 of Pub. L. No. 109-8.

[11] Office of Legislative Affairs, Department of Justice, letter to Chairman Sensenbrenner (October 5, 2005).

[12] Statement of the National Association of Consumer Bankruptcy Attorneys (October 5, 2005).