

## COMMENT

### The Unfinished Business of Bankruptcy Reform: A Proposal To Improve the Treatment of Support Creditors

Amid the controversy surrounding the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (2005 Act),<sup>1</sup> few commentators have focused on the Act's provisions designed to enhance the protection of "support creditors"—a class of creditors consisting mostly of divorcées and single mothers who are owed child support, alimony, or other maintenance but whose former partners have declared bankruptcy.<sup>2</sup> This Comment critiques the recent revisions to the Bankruptcy Code concerning support creditors and concludes that Congress must do more if it wishes to provide meaningful assistance to this vulnerable group.

Proponents of the 2005 Act point to its assignment of higher priority status for matured support claims as evidence of the Act's progressive character.<sup>3</sup> Yet this measure—which bumps support creditors higher up in the queue among other unsecured claimants during liquidation—has little practical value in the vast majority of cases, in which secured creditors' claims exceed the total value

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1. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).
  2. State governments may also become "support creditors," either by providing welfare payments to custodial parents who then assign their support claims to the state, or by directly billing parents for child-related services. See Karen Cordry, *Legislative Update: Treatment of Child Support Claims Under the Proposed Reform Act: Domestic Support and the Bankruptcy Code*, AM. BANKR. INST. J., May 2003, at 47, 47.
  3. See, e.g., William Murphy, *Pols & Politics*, NEWSDAY, May 6, 2005, at A40 (paraphrasing Representative Joseph Crowley's statement that the 2005 Act would "make child support payments the debtor's first priority").

of the debtor's assets, leaving nothing for "priority" creditors of any kind.<sup>4</sup> As one commentator quipped, the bankruptcy reform puts support creditors "first in line to receive nothing."<sup>5</sup>

A more important but less widely perceived consequence of the 2005 Act is that it indirectly jeopardizes support creditors by increasing competition for scarce postbankruptcy resources. Whereas support creditors once occupied a privileged position as one of the few classes of creditors with "nondischargeable" claims,<sup>6</sup> the 2005 Act allows certain lenders, such as commercial creditors, to more easily pursue their claims beyond the point of bankruptcy, pitting these lenders against support creditors in an unstructured battle for the debtor's future income and assets. Because support creditors are far less adept than credit card companies at recovering debts in this unregulated environment, the 2005 Act effectively reduces support creditors' chances of receiving much-needed compensation.

To remedy this problem, I suggest that Congress modify the Bankruptcy Code in three ways. First, Congress should create a statutory hierarchy among nondischargeable claims, with the claims of support creditors taking precedence over those of other unsecured creditors. By establishing a priority system for nondischargeable claims akin to that which currently operates when dividing up the bankruptcy estate,<sup>7</sup> Congress would allay well-founded fears that credit card companies will crowd out vulnerable child support and alimony recipients in the race to recover against the debtor's postbankruptcy assets.

Second, Congress should amend the Bankruptcy Code to include a "springing lien" — a device that automatically grants support creditors the right of first access to a debtor's future income. Such an innovation would prevent

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4. See Ed Flynn et al., *Bankruptcy by the Numbers: Chapter 7 Asset Cases*, AM. BANKR. INST. J., Dec. 2002-Jan. 2003, at 22, 22 ("About 96 percent of chapter 7 cases are closed without any funds collected and distributed to creditors by the assigned trustee."). My assertion assumes that support creditors have unsecured claims, which most do. See Michelle Arnopol Cecil, *Crumbs for Oliver Twist: Resolving the Conflict Between Tax and Support Claims in Bankruptcy*, 20 VA. TAX REV. 719, 728-29 (2001).

5. Trisha L. Baggs, Comment, *Bankruptcy Reform of 2001: A Hollow Victory for Creditor-Spouses*, 34 ARIZ. ST. L.J. 967, 977 (2002).

6. Creditors with nondischargeable claims may recover against the debtor's postbankruptcy assets rather than having their claims swept away by the discharge mechanism, which ordinarily gives debtors a "fresh start."

7. The priority system in bankruptcy establishes the order in which unsecured creditors may recover against a debtor's estate. See generally 11 U.S.C. § 507(a) (2000) (amended 2005) (listing priorities). My proposal of a priority system for nondischargeable claims borrows the same statutory ranking of creditors that Congress has established (and recently revised) for Chapter 7 liquidation purposes. See *infra* notes 27-29 and accompanying text.

commercial lenders from leapfrogging ahead of support creditors by obtaining wage garnishments, a form of secured claim.

Third, Congress should prevent all creditors with nondischargeable claims from claiming against the debtor's future income until any ongoing support-related obligations have been satisfied. This reform would ensure that before paying any outstanding debts—including support-related arrears—debtors would make allowance for their children's and former partners' current expenses.

## I. REFORMS BENEFITING SUPPORT CREDITORS IN THE 2005 ACT

Policymakers have long considered support creditors a particularly vulnerable group. Such creditors often cannot provide for themselves and their children when support payments cease and, unlike commercial creditors, they cannot effectively pool or manage risk. Accordingly, pre-2005 bankruptcy law gave special solicitude to support creditors by designating support-related debts as nondischargeable,<sup>8</sup> allowing support creditors to access otherwise exempt assets,<sup>9</sup> granting support creditors priority status in estate distributions,<sup>10</sup> relaxing the automatic stay for support-collection purposes,<sup>11</sup> and making exceptions to preferential transfer rules for support payments.<sup>12</sup>

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8. 11 U.S.C. § 523(a)(5) (2000) (amended 2005) (designating support-related debts as nondischargeable); *see also* 11 U.S.C. § 523(a)(15) (2000) (amended 2005) (concerning property settlements); 11 U.S.C. § 1328(a)(2) (2000) (amended 2005) (concerning Chapter 13 filings).
  9. Although creditors with nondischargeable claims generally cannot collect against property that has been exempted from the debtor's estate pursuant to federal or state law, the Bankruptcy Code makes an exception for support creditors. 11 U.S.C. § 522(b)-(d) (2000) (amended 2005). *See also* 11 U.S.C. § 522(f)(1)(A) (2000) (amended 2005) (preventing debtors from avoiding judicial liens against exempt property where such liens secure support-related debt).
  10. Prior to 1994, support creditors enjoyed no priority status, meaning their claims could be satisfied only after all secured creditors and priority unsecured creditors had been reimbursed. The Bankruptcy Reform Act of 1994 (1994 Act), 11 U.S.C. § 507(a)(7) (2000) (amended 2005), made matured support claims a seventh-level priority, which in turn triggered the requirement that all Chapter 13 debtors budget for payment of support-related arrears in their debt repayment plans. 11 U.S.C. § 1322(a)(2) (2000) (amended 2005).
  11. 11 U.S.C. § 362(b)(2)(B) (2000) (amended 2005) (allowing support creditors to pursue claims prior to the termination of bankruptcy proceedings provided that they sought recovery against "property that is not property of the estate"). The 1994 Act added exceptions to the automatic stay for actions establishing paternity and modifying maintenance amounts. *See* 1994 Act § 304(b) (amending 11 U.S.C. § 362(b)(2)).
  12. The Bankruptcy Code empowers trustees to avoid "preferential transfers," which are payments made by insolvent debtors to benefit certain creditors at the expense of others. 11

The 2005 Act bolsters these protections in several ways. First, it eliminates the controversial distinction between support claims and marital property settlements. In place of the old balancing test, which required a tribunal to determine whether property settlements would be nondischargeable, the Act creates a brightline rule that all such obligations are nondischargeable.<sup>13</sup> This change will prevent debtors from unfairly mischaracterizing their support debts as property settlements and thereby escaping those obligations.

Second, the 2005 Act broadens the support-related exceptions to the automatic stay. The most important consequence of this reform is that wage garnishments may persist while bankruptcy proceedings are still pending.<sup>14</sup> Related provisions allow for the interception of tax refunds to satisfy support obligations, withholding of licenses from debtors who default on support payments, reporting of overdue support payments to credit agencies, and enforcement of medical-support obligations.<sup>15</sup>

Third, in a much ballyhooed provision, the 2005 Act elevates support claims from seventh to first priority status.<sup>16</sup> Within the new first priority category, the Act creates three subcategories: non-government-held support debts are labeled “1A,” government-held support debts are labeled “1B,” and expenses associated with administering the estate are labeled “1C.” When a trustee has been appointed, 1C costs are reimbursed first, followed by 1A debts, and then 1B debts.<sup>17</sup> Thus, it is now technically correct (and rhetorically powerful) to say that support claims are Congress’s “first priority” at the estate-distribution stage of bankruptcy.

Fourth, the 2005 Act authorizes dismissal of a Chapter 12 or 13 case when a debtor defaults on support obligations that became payable after the filing of bankruptcy.<sup>18</sup> As a result, individual debtors must not only budget for payment of support arrears in any reorganization plan—a requirement that predated the 2005 Act—but also honor recently acquired support obligations as a condition for receiving a discharge. Finally, the 2005 Act requires that trustees explain to

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U.S.C. § 547(b) (2000). The 1994 Act exempted support creditors from this provision, thereby insulating them from costly lawsuits seeking repayment of prebankruptcy support payments to the bankruptcy estate. 11 U.S.C. § 547(c)(7) (2000) (amended 2005).

13. Compare 2005 Act, Pub. L. No. 109-8, § 215, 119 Stat. 23, 54 (to be codified at 11 U.S.C. § 523(a)), with 11 U.S.C. § 523(a)(15) (2000) (establishing a rebuttable presumption that property settlements are nondischargeable).

14. 2005 Act § 214 (to be codified at 11 U.S.C. § 362(b)(2)).

15. *Id.*

16. *Id.* § 212 (to be codified at 11 U.S.C. § 507(a)).

17. *Id.*

18. *Id.* § 213(7) (to be codified at 11 U.S.C. § 1307(c)(11)).

support creditors their rights under Chapter 7, inform them of available child-support-enforcement services, notify child support agencies of all support creditors holding claims, and keep all parties apprised of any discharges that occur.<sup>19</sup>

## II. CRITICISMS OF THE 2005 ACT

In addition to focusing on those provisions of the 2005 Act that specifically address support creditors, it is essential to understand how reforms located elsewhere in the omnibus legislation may undermine the relative position of support creditors, leaving them in a weakened financial position. Because the vast majority of debtors are asset-poor, most support creditors' only prospect for compensation is to recover against a debtor's future income and other postpetition assets.

The 2005 Act increases competition for this all-important pool of postbankruptcy assets in several ways. First, the Act designates a greater number of "luxury good" purchases as nondischargeable. Under the old Code, any goods or services exceeding a total value of one thousand dollars purchased within two months of filing that were not "reasonably acquired for the support or maintenance of the debtor or a dependent of the debtor" were presumed fraudulent and therefore nondischargeable.<sup>20</sup> The 2005 Act substantially reduces the threshold for luxury good purchases and lengthens the relevant time period.<sup>21</sup> These changes allow credit card companies to pursue more frequently their high-interest debts even after bankruptcy is complete. Not surprisingly, commercial lenders are far better equipped than individual support creditors to collect debts from financially strapped debtors, many of whom frequently move, change jobs, and otherwise evade payment.<sup>22</sup>

Second, the 2005 Act increases competition among support creditors. By allowing state governments to seek compensation for support or support-related costs, such as welfare outlays to dependent single parents, the 2005 Act adds another class of creditors with which individual support recipients must compete

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19. *Id.* § 219 (to be codified at 11 U.S.C. §§ 704, 1202, 1302).

20. 11 U.S.C. § 523(a)(2)(C) (2000) (amended 2005).

21. See 2005 Act § 310 (to be codified at 11 U.S.C. § 523(a)(2)(C)) (making presumptively nondischargeable: (1) purchases of \$500 or more from a single creditor made within ninety days prior to filing; and (2) aggregative cash advances of \$750 or more taken within seventy days prior to filing).

22. See Joan Entmacher, *Legislative Update: Treatment of Child Support Claims Under the Proposed Reform Act: How the Bankruptcy Bill Will Affect Women and Children Owed Child Support*, AM. BANKR. INST. J., May 2003, at 49.

to receive their own support arrears.<sup>23</sup> For instance, when a support creditor seeks to recover against a debtor's postbankruptcy assets for support debts accrued prior to her dependency on welfare, she must compete with the same state child support agency to which she assigned all post-welfare support claims.

Third, the 2005 Act increases competition for scarce postbankruptcy assets by reducing the overall likelihood that debtors will receive a discharge. Prior to 2005, many debtors could obtain a fresh start through a Chapter 7 discharge, leaving them better positioned to satisfy their few remaining nondischargeable obligations, such as any outstanding support arrears. The 2005 Act disrupts this process by diverting many debtors into Chapter 13 bankruptcy, where they must complete a demanding multiyear repayment plan in order to qualify for a discharge. In the past, only thirty percent of debtors have successfully completed their Chapter 13 plans and received a discharge,<sup>24</sup> and this percentage will likely decline in light of new requirements that debtors budget for additional priority debts and secured claims. By making it harder for debtors to successfully complete Chapter 13 plans, the 2005 Act increases the likelihood that *all* outstanding debts will remain nondischarged, in turn forcing support creditors to compete with a broader array of creditors for the same scarce postbankruptcy resources. Whatever benefits the 2005 Act may confer upon support creditors in the Chapter 13 process—such as authorizing Chapter 13 dismissals when current support obligations go unpaid—are more than offset by the Act's indirect effect on the rates of discharge.<sup>25</sup>

On balance, the 2005 Act does little to improve, and may even worsen, the relative position of support creditors.<sup>26</sup> Unfortunately, bankruptcy reformers have thus far concentrated their energies on making micro-adjustments to the existing priority system while ignoring the pressing problem of unregulated competition among creditors with nondischargeable claims. Indeed, it is a strange irony that the Bankruptcy Code goes to such lengths to privilege

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23. *Id.*

24. See Marianne B. Culhane & Michaela M. White, *Taking the New Consumer Bankruptcy Model for a Test Drive: Means-Testing Real Chapter 7 Debtors*, 7 AM. BANKR. INST. L. REV. 27, 60 (1999).

25. See Entmacher, *supra* note 22; Linda Lea M. Viken, *Legislative Update: Treatment of Child Support Claims Under the Proposed Reform Act: The Overall Impact of H.R. 975*, AM. BANKR. INST. J., May 2003, at 49, 49-50.

26. In fact, the 2005 Act represents only the latest manifestation of Congress's growing tendency to saturate the postbankruptcy landscape with nondischargeable claims. See, e.g., Keith N. Sambur, Note, *The Sarbanes-Oxley Act's Effects on Section 523 of the Bankruptcy Code: Are All Securities Laws Debts Really Nondischargeable?*, 11 AM. BANKR. INST. L. REV. 561, 561-62 (2003) (describing recent amendments to the Bankruptcy Code that exempt from discharge all debts arising from violations of federal or state securities laws).

support creditors at the estate distribution stage yet does nothing to help those same creditors during the far more important postbankruptcy period.

### III. PROPOSALS

To remedy this problem, I propose that Congress: (1) place support claims atop a new hierarchy of nondischargeable claims; (2) establish a “springing lien” that ensures support creditors the right of first access to debtors’ future incomes; and (3) require that debtors fulfill ongoing support obligations prior to satisfying any nondischargeable debts.

First, Congress should establish a hierarchy for nondischargeable claims that operates in a manner akin to the priority system for the distribution of debtors’ estates. Just as trustees disburse estate assets according to a statutorily predetermined ranking of creditors, bankruptcy courts could establish, according to guidelines set forth by the Bankruptcy Code, a fixed order in which all outstanding nondischarged claims will be satisfied against future income or other postpetition assets.<sup>27</sup>

To determine the proper hierarchy for nondischargeable claims, Congress should adopt the same priority ranking that has already been established (and refined in the 2005 Act) for use in liquidation proceedings.<sup>28</sup> According to this model, support creditors would be designated as first priority nondischargeable claimants, reflecting their high level of personal financial vulnerability, strong dignitary interests in receiving compensation, minimal ability to pool and manage risk, and significant likelihood of becoming dependent on taxpayer-subsidized benefits in the event of not receiving alimony or child support.<sup>29</sup>

My proposal for a postpetition priority system would apply to unsecured claims and wage garnishments only, leaving all other nondischargeable secured claims to be satisfied in accordance with priority rules specified under

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27. To be precise, most creditors could recover only against *nonexempt* postpetition assets. Only a small group of creditors – including support creditors – are statutorily permitted to recover against exempt assets. See *supra* note 9 and accompanying text.

28. Under the current priority ranking, administrative expenses are reimbursed first, followed by support-related claims, “gap creditor” claims, claims for wages and commissions earned immediately prior to filing, contributions to employee benefit plans, debts owed to grain producers and fishermen, and so on. See 11 U.S.C. § 507(a) (2000) (amended 2005).

29. See Cecil, *supra* note 4, at 730-32 (describing these criteria as the basis for the high priority given to support claims in the status quo).

applicable nonbankruptcy law.<sup>30</sup> Were Congress to introduce a priority system for unsecured nondischargeable claims along the lines I suggest, commercial lenders would likely respond by seeking wage garnishments (a form of secured interest) as a condition for extending credit, thereby ensuring more favorable postbankruptcy treatment of their claims. By obtaining a garnishment lien, commercial lenders would effectively leapfrog ahead of support creditors who, despite having first priority among unsecured nondischargeable claimants, could not recover against a debtor's postbankruptcy income until after these secured creditors had satisfied their debts in full. Anticipating this response, Congress should introduce a "springing lien" that would automatically elevate all support debts to the level of priority secured claims in the event that any non-support creditor seeks to obtain a garnishment lien.<sup>31</sup> Such a device—which amounts to a statutory lien triggered by the filing of rival nondischargeable claims against income—would ensure support creditors a right of first access to a debtor's future earnings. To address the possibility that a commercial lender might prematurely collect against a debtor's future income (or that a debtor might deliberately repay commercial debts before support-related debts), the Bankruptcy Code should include a provision allowing support creditors to seek disgorgements from such lenders in the amount that support creditors would have received had the postbankruptcy priority system been obeyed. In response to such measures, commercial lenders might find it in their interest to require, either as a condition for receiving credit or as a basis for interest rate calculations, that all prospective borrowers notify them of any outstanding support obligations. To facilitate this response, Congress could encourage state child support authorities to share with credit agencies all records of outstanding child support arrears.

A third way that Congress could benefit support creditors would be by establishing that no claimants, whether secured or unsecured, may recover against a debtor's postpetition assets until all currently accruing support-related obligations have been fulfilled. Thus, neither support arrears nor other debts would be paid until a debtor had satisfied all current support obligations and made provisions to satisfy such obligations into the future. Without such an income set-off provision, debtors might use their entire disposable income to satisfy debts accumulated prior to bankruptcy, leaving them without resources to make ongoing support payments to their dependents.

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30. For instance, my proposal would not alter the treatment in bankruptcy of non-wage-related security interests (i.e., securities in property and fixtures) that are subject to the provisions of Article 9 of the Uniform Commercial Code.

31. To be precise, the same priority ranking that would govern unsecured nondischargeable claims would then dictate the order in which garnishment liens were satisfied.



In the above discussion, I have highlighted the need for a priority system to structure compensation of nondischargeable debts that accrued prior to bankruptcy and “passed through” the discharge process. Yet policymakers implementing my proposals would also need to resolve how debts incurred after bankruptcy should be incorporated into the priority system. For instance, after the point of discharge Chapter 7 debtors may incur new tax obligations or high-interest credit card debts that must then be taken into account. Likewise, debtors who fail to complete their Chapter 13 plans will have nondischarged debt that must be satisfied. Rather than distinguishing between nondischargeable debts, debts incurred postdischarge, and nondischarged debts, however, a better approach may be to group all such debts together by class of creditor<sup>32</sup> and then compensate creditors according to the newly established priority ranking.<sup>33</sup>

Finally, in order to strike the appropriate balance between preserving work incentives and obtaining compensation for nondischargeable debts, Congress might wish to set an upper limit on the percentage of a debtor’s income that may be subject to wage garnishment at any given time. While this topic is ultimately beyond the scope of this Comment, it is an important avenue for further consideration.

## CONCLUSION

For all the public hand-wringing about the need for the Bankruptcy Code to protect support creditors, this financially vulnerable group continues to receive surprisingly little in the way of meaningful assistance. This puzzle largely stems from the fact that support claims enjoy no protection in the increasingly saturated, highly competitive, and virtually unstructured postbankruptcy claims process. After years of hollow promises, it is now time for Congress to reform the Bankruptcy Code in a way that will actually achieve the noble goal of protecting support creditors.

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32. Congress could use the “first-in-time” principle to resolve claims within the same class of creditor, such as prebankruptcy versus postbankruptcy credit card debt.

33. This approach would produce varying results depending on when postbankruptcy claims were processed. If the bankruptcy court were to process all outstanding debts immediately following the bankruptcy, then nondischargeable debts would feature prominently in the priority distribution. But were the court to process claims later, or even at regular intervals, other post-discharge and nondischarged debts would then factor into the priority distribution.