

CHAPTER 13 REPAYMENT PLANS

The concept of the consumer repayment plan developed in Birmingham, Alabama in the 1930s as a means for wage earners to repay their debts through a court-supervised program.⁶⁰¹ Congress adopted this model nationwide when it enacted Chapter XIII in 1938, and again when it enacted Chapter 13 in 1978. The districts that provided the initial models for the modern day Chapter 13 maintain their Chapter 13 high filing rates even today.⁶⁰²

The legislative history of the Bankruptcy Reform Act of 1978 establishes that Congress sought to promote the use of Chapter 13 in appropriate cases. Many debtors' representatives, judges, trustees and creditor representatives have spoken in strong support of Chapter 13. Chapter 13 enables families to get caught up on house and car loans while it provides a mechanism for repayment of unsecured debt. Although debtors might choose Chapter 13 over Chapter 7 for a variety of reasons, curing mortgage and loan defaults is a primary incentive for them to do so.

While the concept of a repayment plan is valuable, the actual implementation of the Chapter 13 program could be improved on several fronts. The high non-completion rate of Chapter 13 plans is cause for substantial concern. For more than a decade, two-thirds of all Chapter 13 plans have failed before the debtor completes payments, and sometimes before unsecured creditors have received anything at all. While some of the debtors convert to Chapter 7 when plan payments become

⁶⁰¹ See Henry H. Haden, *Chapter XIII Wage Earner Plans—Forgotten Man Bankruptcy*, 55 KY. L. J. 564 (1966).

⁶⁰² Teresa A. Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J. L. & PUB. POL. 801, 843 (1994). The 1970 Commission noted that in some areas, debtors may not be aware of any option to them under the Bankruptcy Act except Chapter XIII. 1973 REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. No. 93-137, 158 (1993). See also Michael Bork & Susan D. Tuck, Administrative Office of the United States Courts, *Bankruptcy Statistical Trends: Chapter 13; Adjustment of Debts of an Individual with Regular Income (Working Paper 1)*, (Jan. 1994) (finding that Chapter 13 most commonly found in Southeastern states, excluding Florida, and that Chapter 13 cases had accounted for more than 50% of total case filings since 1981 in nine districts, eight of which were in Southeastern states, and that Chapter 13 filings in Alabama, Tennessee, Georgia and North Carolina had increased steadily as percentage of total filings since 1988, reaching combined 61 % in 1993).

infeasible, about half of all debtors who initially file for Chapter 13 are dismissed with no resolution of their financial problems and no discharge.⁶⁰³

Noncompletion may have a number of causes. Some commentators suggest that debtors frequently encounter repeated financial difficulties or face new crises, such as the loss of a job or a health emergency. Bankruptcy does not insulate against subsequent disaster. The same kinds of spotty employment or medical problems that caused debtors' initial financial problems may reemerge, or new problems might appear. Subsequent difficulties, coupled with the higher "catch-up" payments on secured debt, can foil well-intentioned repayment efforts. Others suggest that debtors propose unrealistic plans that are doomed from the inception, sometimes due in part to inadequate advice. In an effort to meet the requirements of the Bankruptcy Code in the treatment of certain creditors or to meet the informal payment requirements of some judges or trustees, debtors may commit to payment plans that would consume or exceed every dollar of discretionary income, and make optimistic assumptions about their income, expected over-time pay, and so on, but do not allow for even minimal unforeseen expenses. Some simply cannot sustain such payments over time. Another theory holds that some debtors file for Chapter 13 never intending to complete their payments; they may cure a default on a secured debt on a home or a car, then leave bankruptcy when their secured debt payments are current. A related, but more troubling theory suggests that some number of Chapter 13 debtors have filed only to get an automatic stay to stop a foreclosure or eviction. When they are unable to bring the underlying obligation current, they dismiss with an intent to buy another automatic stay by filing again.

Whatever the causes for the high rate of noncompletion, several consequences are troubling. First, the many dismissals serve as a reminder that under the current system, choosing Chapter 13 over Chapter 7 does not guarantee meaningful repayment to unsecured creditors. For example, in the many jurisdictions that permit the deferral of unsecured debt payment until the end of the plan, unsecured creditors may receive a negligible collective payout. For debtors who file only to avoid foreclosure or eviction, payouts range from nominal to non-existent.

In addition, for the debtors who filed for legitimate purposes but who are too poor or too disaster-prone to complete their plans, filing and dismissing add to their financial burdens. When noncompletion leads to dismissal rather than discharge, as it so often does, debtors exit the system having paid a substantial filing fee and

⁶⁰³ Michael Bork and Susan D. Tuck, Administrative Office of the U.S. Courts, Bankruptcy Statistical Trends; Chapter 13; Dispositions (Working Paper 2) (October 1994) (studying termination data for Chapter 13 cases filed between 1980 and 1988); TERESA A. SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (1989). For additional details, see discussion *infra*, on dismissal and conversion.

attorneys' fees but have not discharged any debt. Because interest continues to accrue and compound on nondischarged debt, the debtor may have an even higher debt load after making a determined—but ultimately unsuccessful—effort to pay off debts.

The Commission hearings were peppered with illustrations of the lack of uniformity in Chapter 13 plan confirmation requirements. Court discretion is an important and necessary part of any judicial proceeding, and judges must be called upon to apply legal rules to novel and perplexing sets of facts. However, the nonuniformity of Chapter 13 plans is more deeply rooted. Chapter 13 practices differ dramatically from state to state, district to district, and even from judge to judge in the same district. Debtors in very similar circumstances encounter extremely different Chapter 13 systems. These variations in the systems determine whether debtors are eligible for Chapter 13 relief at all, and how much they will have to pay for that relief.

Some courts confirm plans paying zero percent to unsecured creditors. Other courts condition confirmation on payment of high percentages of unsecured debt. A Chapter 13 debtor who is permitted to devote all disposable income to repaying nondischargeable debt will emerge from bankruptcy much better off than a debtor who is required to make *pro rata* payments on all nonpriority unsecured debt -- dischargeable or nondischargeable -- leaving the debtor with much larger nondischargeable debts post-bankruptcy. Some observers are not troubled by this variation. They believe that it reflects appropriate differences in community values. While some variation may be a healthy part of a legal system, the fundamental fairness of a system is undermined when the interpretations are so divergent that they alter the basic requirements of the Chapter 13 bargain.

An overlay of divergent local interpretations onto the already complex Chapter 13 system creates a situation in which expert legal advice is necessary to develop, confirm, modify, and complete a Chapter 13 plan. For the majority of debtors who cannot afford expensive advice, two results may occur. First, some debtors encounter attorneys who give the low-cost advice to file Chapter 7. Second, the debtors who end up in the complicated Chapter 13 system without good advice are unlikely to be able to navigate their way through the process. While there will never be a substitute for good legal advice, no one benefits when a system for financially distressed consumers becomes a trap for the unwary. The default rules should be sufficiently sensible to lead to the proper results without high administrative costs.

Ironically, the same system that is too complicated for the most needy debtors can work to the benefit of the few savvy debtors who can exploit some provisions to extraordinary advantage. With few exceptions, debtors have almost unlimited access to Chapter 13 even if they have filed numerous cases previously in quick succession. The bankruptcy court clerk is required to accept the bankruptcy petition of a debtor who files the appropriate papers and pays the required fee. This filing triggers an automatic stay. Creditors bear considerable expense when a debtor repeatedly files

Chapter 13 merely to forestall foreclosure, eviction, or other collection action, which is compounded by the expense of initiating additional proceedings in the bankruptcy court. The empirical data are insufficient to support an inference of a widespread trend of improper repeat filings, but there is sufficient regional and anecdotal documentation that the system permits an individual and/or co-owners or co-tenants to file repeatedly for Chapter 13 merely for its injunctive powers.

Finally, common sense would dictate that credit reports should identify those debtors who successfully complete their payment plans, perhaps giving them better access to future credit than debtors who pay no debts out of future income. However, this currently is not the case. Not only do credit reports provide incomplete information regarding a debtor's repayment attempts, but according to many accounts, Chapter 7 debtors have easier access to credit than Chapter 13 debtors. If the system is really supposed to encourage debtors to file for Chapter 13, the incentives currently are perverse.

All of these issues are addressed in the following Recommendations. While these Recommendations reflect the goal of encouraging debtors to choose Chapter 13 and to complete their plans, it remains to be seen if the rate of successful plan completion can be improved substantially notwithstanding the fact that completing a three to five year payment plan can be a difficult undertaking for financially troubled families. In the meantime, the recommended changes were designed to increase the fairness and efficiency of the Chapter 13 system for both debtors and creditors.

1.5.1 *Home Mortgages*

A Chapter 13 plan could not modify obligations on first mortgages and refinanced first mortgages, except to the extent currently permitted by the Bankruptcy Code. Section 1322(b)(2) should be amended to provide that the rights of a holder of a claim secured only by a junior security interest in real property that is the debtor's principal residence may not be modified to reduce the secured claim to less than the appraised value of the property at the time the security interest was made.

While equality of distribution among creditors is a central tenet of the bankruptcy system, some creditors' claims get special treatment for policy reasons. Therefore, although the Bankruptcy Code generally requires secured debts exceeding the value of collateral to be "stripped down," and thus bifurcated into secured and unsecured claims,⁶⁰⁴ home mortgages are treated differently. Prior to the Supreme

⁶⁰⁴ 11 U.S.C. § 506 (1994).

Court's decision in *Nobelman v. American Savings Bank*,⁶⁰⁵ some courts held that the antimodification policy for home mortgages did not preclude debtors from stripping down mortgages.⁶⁰⁶ The Bankruptcy Code now explicitly provides that certain home mortgage loans cannot be stripped or modified.⁶⁰⁷

This special treatment for home mortgages is limited. The Bankruptcy Code does not provide an exception to all holders of liens and interests on homes. For example, a mortgage can be bifurcated into its secured and unsecured portions if the house is not the debtor's "primary residence." Likewise, Chapter 13 does not prohibit modification of a mortgage loan if the loan also is secured by other collateral.⁶⁰⁸ In addition, section 1322(c)(2) authorizes a stripdown of an undersecured residential mortgage if final payment would become due during the course of the Chapter 13 plan.⁶⁰⁹ Moreover, a number of courts have held that a

⁶⁰⁵ 113 S. Ct. 2106 (1993).

⁶⁰⁶ See, e.g., *Wilson v. Commonwealth Mortgage Corp.*, 895 F.2d 123 (3d Cir. 1990); *Houglan v. Lomas & Nettleton Co.*, 886 F.2d 1182 (9th Cir. 1989); *Hart v. Hart*, 923 F.2d 1190 (10th Cir. 1991); *Bellamy v. Federal Home Loan Mortgage Co.*, 962 F.2d 176 (2d Cir. 1992). See also *Todd Mason, Lenders Cringe As Judges Chop Mortgage Value*, WALL ST. J., Sept. 26, 1990. Liens therefore were stripped but the interest rate and monthly payments remained the same, thus mortgage lenders would receive the same regular monthly payments but for a shorter term. In addition, courts formerly permitted Chapter 7 debtors to strip first mortgages until the Supreme Court deemed this impermissible in *Owensup v. Timm*, 502 U.S. 410 (1992). *Nobelman*, 113 S.Ct. at 2110.

⁶⁰⁷ 11 U.S.C. § 1322, 1325 (1994).

⁶⁰⁸ 11 U.S.C. § 1322(b)(2) (1994). *In re Johns*, 37 F.3d 1021 (3d Cir. 1994) (if original residential loan documents included additional security, loan not protected from modification, regardless of subsequent foreclosure judgment that arguably extinguished security interest in additional collateral); *In re Hammon*, 27 F.3d 52 (3rd Cir. 1994) (debtor can bifurcate when creditor has additional security); *In re Libby*, 200 B.R. 562 (Bankr. D.N.J. 1996) (mention of additional security in loan documents eliminates antimodification protection even if additional security never actually existed); *In re Escue*, 184 BR 287 (Bankr. M.D. Tenn. 1995) (inclusion of "refrigerator, spare heater, and similar items," constituted additional security). But see *PNC Mortgage Co. v. Dicks*, 199 B.R. 674 (N.D. Ind. 1996) (majority of case law suggests that "boiler plate" interests not additional security); accord *In re Lievsay*, 199 B.R. 705 (B.A.P. 9th Cir. 1996). Tax liens on homes, which are not consensual security interests, may be subject to modification in Chapter 13. See, e.g., *In re DeMaggio*, 175 B.R. 144 (Bankr. D.N.H. 1994) (nonconsensual tax lien not consensual security interest, not protected from modification in Chapter 13).

⁶⁰⁹ Section 1322(c) provides: Notwithstanding subsection (b)(2) and applicable nonbankruptcy law, (2) in a case in which the last payment on the original payment schedule for a claim secured only by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title. 11 U.S.C. § 1322(c)(2) (1994); see also

mortgage can be modified if it is wholly unsecured.⁶¹⁰ None of the Commission's Recommendations would alter any of these rules.

Notwithstanding these "exceptions to the exception," the special protection for mortgage lenders in the Bankruptcy Code is relatively consistent with pervasive federal policies promoting home ownership.⁶¹¹ Protection against modification and stripdown was designed to insulate home mortgage lenders to preserve families' access to home purchase financing. By eliminating the additional hurdles to mortgagees' efforts to collect the full amount of their debts from homeowners, the theory goes, mortgage lenders will be willing to take on higher risk borrowers and keep mortgage rates lower.

Home mortgages also provide a valuable source of financing for other purposes. Mortgage loans have become an increasingly popular method to finance important family life events, such as sending a child to college.⁶¹² In many cases, this

In re Young, 199 B.R. 643, 646 (Bankr. E.D. Tenn. 1996) (plain meaning of new provision indicates that plan may modify mortgage where payment becomes due during life of plan). Marianne B. Culhane, *Home Improvement? Home Mortgages and the Bankruptcy Reform Act of 1994*, 29 CREIGHTON L. REV. 467, 490 (1996), 5 COLLIER ON BANKRUPTCY ¶ 1322.14B (Lawrence P. King et al. eds., 15th ed. 1996). *But see Witt v. United Companies Lending Corp.*, 113 F.3d 508 (4th Cir. 1997) (finding that section 1322 (e)(2) is ambiguous and that legislative history implies that only payment schedule could be modified and the claim could not be bifurcated).

⁶¹⁰ See, e.g., *In re Purdue*, 187 B.R. 188 (S. D. Ohio 1995); *In re Geyer*, 203 BR 726 (Bankr. S.D. Cal. 1996); *In re Vaillancourt*, 197 B.R. 464 (Bankr. M.D. Pa. 1996); *In re Hornes*, 160 B.R. 709 (Bankr. D. Conn. 1993); *In re Plouffe*, 157 B.R. 198 (Bankr. D. Conn. 1993); *In re Williams*, 161 B.R. 27 (Bankr. E.D. Ky. 1993); *In re Lee*, 161 B.R. 271 (Bankr. W. D. Okla. 1993).

⁶¹¹ Federal income tax laws, state property tax laws, the Federal Housing Administration, the Community Reinvestment Act, Veteran's Administration loan guarantee programs, Fannie Mae and Freddie Mac, low income housing construction subsidies, mortgage securitization programs, and financial institution regulations are just a sampling of the programs designed in part to facilitate homeownership.

⁶¹² Fewer than one percent of all institutions offered home equity loans and lines of credit in 1980, while 80% of banks and 65% of savings and loan institutions offered home equity loans in 1989. U.S. General Accounting Office, *Tax Policy: Many Factors Contributed to the Growth of Home Equity Financing in the 1980s*, app. IV, 67 (1993). Consumer demand likely reacted to the favorable tax treatment conferred on home equity borrowers, while attractive banking regulations provided incentives to lenders to expand this area of lending. By 1991, second mortgages comprised 12% of home mortgage debt, having increased three-fold over the prior decade; this increase is attributable mainly to growth in home equity lines of credit offerings. *Id.* at 9. Moreover, the amount of mortgage debt outstanding grew three times faster than the value of homes in the same period. *Id.* Loans grew from \$1 billion in 1981 to \$132 billion in 1991. *Id.* at 8, Table 1: Dollars Outstanding and Growth Rates for Home Equity Financing, *Id.* at 8. Traditional second mortgages increased from \$59 to \$225 billion in the same period. *Id.*

method of financing has advantages to the borrower. Tax advantages provide incentives to finance through home equity loans.⁶¹³ Furthermore, traditional lenders generally grant these loans and lines of credit at competitive interest rates that are substantially lower than unsecured credit. These advantages encourage families to take the risk associated with pledging one's home to secure a loan.

Families appear to be accepting these incentives to borrow against their homes. As access to home equity loans grows, consumers are increasing their debt loads by borrowing against their homes.⁶¹⁴ Homes are mortgaged more than ever, with the Federal Reserve reporting a loan-to-value ratio of about 64% in 1996.⁶¹⁵ Homeowners in bankruptcy have borrowed against their homes in even larger proportions than other Americans.⁶¹⁶ All signs indicate that the access will continue

⁶¹³ See Francesca Eugeni, *Consumer Debt and Home Equity Borrowing, Economic Perspectives*, Federal Reserve Bank of Chicago 4 (Mar./Apr. 1993) (most of initial surge in home equity lending from 1986 to 1988 occurred as customers were trying to take advantage of interest deductibility on mortgage loans and were using home equity borrowing as substitute for other types of credit and as source of funds to repay more expensive outstanding debt). Congress seriously considered but rejected the elimination of this tax benefit for non-purchase money mortgages. See generally Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 *TUL. L. REV.* 373 (1994).

⁶¹⁴ The Federal Reserve reported in February that consumers are compensating for the recent slowdown in credit-card growth by taking out more home-equity loans, which have become more easily attainable. 12.5% of the banks surveyed had eased terms for home equity loans in the fourth quarter, while none tightened their standards. *Home-Equity Loans Rise as Banks Tighten Credit-Card Terms*, *WALL ST. J.*, Feb. 11, 1997.

⁶¹⁵ Jeff Bailey, *Consumer Loan Demand Remains Strong; Big Finance Companies Say Business is Still Robust Despite Fears Over Debt*, *WALL ST. J.*, Oct. 25, 1996, A2 (reporting that consumer installment debt, adjusted to include car leases and home equity loans, has reached record high of nearly 30% of disposable income).

⁶¹⁶ Less than 14% of homeowners in the general population had more than one mortgage on their homes in 1991, American Housing Survey for the United States in 1991, Current Housing Reports H150/91, Table 2-19, Income Costs, and Mortgage - Occupied Units (Washington: Bureau of the Census 1993), as compared to the 27.2% of home owning debtors in bankruptcy that had more than one mortgage at that same time, according to one empirical study. TERESA A. SULLIVAN, ELIZABETH WARREN, & JAY L. WESTBROOK. *FRAGILE MIDDLE CLASS*, (forthcoming) This percentage may be even higher; the constitution of one of the states comprising the study, Texas, has disallowed second mortgages for more than 150 years. However, the Texas legislature has recently revisited this question and the citizens of Texas will vote in early November 1997 on a constitutional amendment allowing home equity loans under limited circumstances. See Proposed Constitutional Amendment -- Homestead Property -- Encumbrances; Joint Resolution, 1997 Tex. Sess. Law Serv. HS. Jt. Res. 31, (VERNON'S 1997). Lenders are gearing up for this new lending opportunity. See Steve McLinden, *Associates First Capital To Field Home-Equity Calls; The Company Will Hire and Keep 230 Workers Even If State Voters Don't Approve the Lending Proposal* Nov. 4, FORT WORTH STAR-TELEGRAM, Oct. 3, 1997; Patrick Barta, *Lenders Brace for*

to increase. Home equity loans now can be obtained through automated loan machines in supermarkets and malls,⁶¹⁷ and changes in lending regulations now permit pre-approved solicitations and advertisements of second mortgages.⁶¹⁸

Many of these families obtain home equity loans from lenders that use less conservative lending practices. These more aggressive lenders tend to offer interest rates and terms that are not appreciably better than unsecured credit and often double the conventional first mortgage loan rate.⁶¹⁹ Factoring in points, closing costs, and prepayment penalties, the effective interest rate may climb even higher. This leads some to question whether too much home equity financing “endanger[s] the financial health” of America’s families.⁶²⁰

Among these high interest home equity loans, some mortgages are partly unsecured as of the day the loan is made; the lender makes a larger loan or extends

Surge in Home Loans, WALL ST. J., Aug. 20, 1997.

⁶¹⁷ Nancy Ann Jeffrey, *Attention Shoppers: Get a Loan While Picking Up Groceries*, WALL ST. J., Dec. 20, 1995.

⁶¹⁸ Carey Gillam, *Nation Bank Tries Ultra-High-Pressure Sales*, 162 AM. BANKER, May 7, 1997, at 6 (explaining that sales associates are expected to aim for selling nearly twenty loan products per day, and announcing intent to mail home equity loan preapprovals to 1.2 million customers); Edward Kulkosky, *Pipeline Coming: Easier Pre-Approval of Equity Loans*, 162 AM. BANKER, May 7, 1997, at 9 (quoting consumer finance company saying that Americans have millions of home equity waiting to be tapped). This may well be a conservative estimate, for others generally speculate that the number is in the billions or trillions.

⁶¹⁹ See, e.g., Memorandum from Gary Klein Re: high rate/high cost loans (June 9, 1997) (attaching high loan documentation for high percentage mortgages, with APRs ranging from 12.78 - 17.103%); Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government’s Promotion of Home Equity Financing*, 69 TUL. L. REV. 373, 376 (1994) (family required by home equity lenders to pay off their existing installment land contract that carried an 8% interest rate).

⁶²⁰ “These Home-Equity Loans Could Endanger Your Financial Health,” CHI. TRIB., May 21, 1997. See also Susan Pulliam, *Big Banks Are Getting Roiled as They Follow ‘Subprime Lenders’ on Easier Home Mortgages*, WALL ST. J., Mar. 5, 1997, C2 (reporting that notwithstanding a 10% total annual default rate, certain subprime lenders are predicted to generate as much as \$3 billion in 1997 by charging interest rates exceeding 14.5 percent); Jeff Bailey, *Lunchpail Lending; HFC Profits Nicely By Charging Top Rates on some Risky Loans; Big Banks Join the Trend, But Consumer Advocates Suspect ‘Sucker Pricing’*, WALL ST. J., Dec. 11, 1996 (discussing how home equity loans typically are marketed to consumers “already wallowing in debt,” discussing typical non-bank lender selling loans at over 15%).

more credit than the property's worth.⁶²¹ Under this relatively new phenomenon, some lenders encourage debtors to borrow over 100%—and sometimes up to 125%—of the value of their homes at higher-than-market interest rates.⁶²² Unlike mortgages that are fully secured until the market declines, these junior mortgages are taken on a partially unsecured basis and should be treated accordingly in the bankruptcy process.

These high leverage loans are the subject of the Commission's Recommendation.⁶²³ The Commission proposes that a junior mortgage lender should be treated as a fully secured creditor only to the extent it was secured when it made the loan. The only effect of the Proposal is to treat the unsecured portion of the loan like other unsecured debt. The remainder of the loan would enjoy the antimodification protection to the extent that current law provides. Some lenders also make undersecured *first* mortgage loans, but the Commission's Recommendation does not include first mortgage loans. This Recommendation is similar in intent, although not identical in detail, to provisions in H.R. 6020 and S.1985, two bills that led up to the Bankruptcy Reform Act of 1994.⁶²⁴

This Recommendation is also consistent with underlying federal policies promoting home ownership. High leverage loans put homeownership at risk. If creditors making loans in excess of the home's value can demand full repayment or

⁶²¹ "Negative equity" home equity loans are becoming increasingly prevalent, even as first mortgages. Susan Fullam, *Big Banks Are Getting Roiled as they Follow 'Subprime Lenders' on Easier Home Mortgages*, WALL ST. J., Mar. 5, 1997, C1 (explaining how Dan Marino, spokesperson for one of these lenders, tells television audience, "you don't need any equity. All you need is a phone").

⁶²² "Less than one-tenth of conventional mortgage loans had LTVs of greater than 90% at the start of the decade. At their peak of popularity in mid-1995, 90% plus LTV loans were closing in on one-third of conventional mortgage loan originations. Mortgage loans equal to 125% of house values have also become increasingly common." Mark M. Zandi, *The Lender of First and Last Resort*, REGIONAL FIN. REV. at 3 (July 1997).

⁶²³ Congress has legislated regarding high rate loans in other contexts. See Home Ownership and Equity Protection Act, 15 U.S.C. § 1639 (1994).

⁶²⁴ H.R. 6020 would have permitted stripdown of undersecured mortgages on the debtor's personal residence, but would have limited stripdown of first mortgages to the extent they were unsecured from the time the mortgage interest attached to the property. H.R. REP. NO. 102-996, (1992). S. 1985, by contrast, would have permitted the modification of claims of junior mortgagees that were partially unsecured when the interest attached, but the extent to which they could be modified does not seem to be limited by the value at the time of attachment. S. 1985, 102nd Cong., (1992). The introduction of these bills preceded the Supreme Court's decision in *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), which held that the Chapter 13 anti-modification provision prevented mortgagee's claims from being bifurcated into secured and unsecured portions pursuant to section 506.

can force a foreclosure, some borrowers will lose their homes. Debtors with second and third mortgages that exceed the value of their homes are less likely to confirm a Chapter 13 plan, thereby yielding no payments to any other creditors.

The home mortgage market should not be affected adversely by this Recommendation. Underwriting standards of traditional mortgage lenders preclude high loan-to-value mortgages, particularly those in which the loan exceeds the value of the collateral. They use strict underwriting standards, and the maximum combined home loan to value ratio for bank mortgages at loan origination generally falls around 75%. The Federal Home Loan Mortgage Corporation (Freddie Mac) does not purchase high loan-to-value home equity lines of credit. Second mortgage loans constituted less than one percent of the holdings of the Federal National Mortgage Association (Fannie Mae) and less than one half of one percent of Freddie Mac's holdings of total single family mortgages in 1993, and the percentage has not changed appreciably since then.⁶²⁵ Like a significant segment of the home equity loans,⁶²⁶ high leverage mortgages are packaged into securities but are sold in a separate securities market. Any risk associated with these mortgages is therefore diffused through securitization.

This Proposal takes a very modest step that should not have any appreciable effect on mortgage pricing. Empirical evidence does not support the allegation that treating home mortgage loans more like other secured debts would affect mortgage pricing. For example, in predicting the effect of different collection laws on mortgage rates, empirical studies of state mortgagor protection statutes have demonstrated that

⁶²⁵ Federal National Mortgage Association, 1992 Annual Report 33 (1993); Federal Home Loan Mortgage Corporation, 1992 Annual Report 55 (1993). Representatives of Freddie Mac confirm that the percentage has not increased substantially since then. Likewise, the FHA and GNMA programs deal predominantly with purchase money mortgages. A representative of Freddie Mac testified before the Senate Judiciary Committee that "Freddie Mac's principal business is purchasing first mortgages and also home improvement loans, although the home improvement loans are a much, much smaller part of our portfolio and a much smaller part of our securities. Therefore, our primary concern would be to extend the protection against cramdowns to first mortgages and also to home improvement loans. With respect to other mortgages which may exist on the debtor's primary residence, we really don't have a position as to that, and it really doesn't impact on our line of business." *Hearing Before the Subcommittee on Courts and Administrative Practice of the Committee on the Judiciary*, 102d Cong. (1991). Other associations' representatives who testified against cramdown of undersecured mortgages at this hearing spoke almost exclusively in terms of first mortgages.

⁶²⁶ See Francesca Eugeni, *Consumer Debt and Home Equity Borrowing*, Economic Perspectives, Federal Reserve Bank of Chicago 7 (Mar./Apr. 1993) (securitization of home equity loans and lines of credit has been growing at rapid pace since 1989). "In 1991, new issues of securities backed by home equity loans and lines of credit reached an unprecedented \$10 billion, with 37 percent of home equity lines of credit securitized," which was estimated to grow to 42% in 1992. *Id.*

mortgage interest rates are relatively insensitive to the existence of mortgagor protection laws.⁶²⁷

This Proposal would limit the preference that high leverage mortgagees receive under current law. Permitting modification of partially secured junior mortgages comports with the continuing effort to treat like creditors more alike.⁶²⁸ However, it does not go all the way to providing equal treatment to similarly situated creditors. Treatment keyed to the value of the property at the time of the loan is not consistent with the general approach to value property during the bankruptcy proceeding. In other instances in bankruptcy, a creditor's secured status is calculated during the course of the bankruptcy. Using loan valuation may intensify the incentive for lenders to over-appraise collateral at the inception of the loan, which might undercut the intent of the Recommendation and create other problems outside of bankruptcy. In addition, families in Chapter 13 may not be able to afford to contest that appraisal, which means that lenders might prevail in most cases regardless of the merits of the appraisal. However, the Proposal takes a first step toward treating all loans in accordance with economic reality. The valuation approach used here is born of compromise, not principle.

1.5.2 Valuation of Collateral

Valuation of Property

A creditor's secured claim in personal property should be determined by the property's wholesale price.

⁶²⁷ See, e.g., Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489 (1991) (50-state empirical analysis of mortgage protection laws and mortgage rates). Professor Schill has argued that, if anything, such mortgagor protection laws might promote economic efficiency because they encourage lenders to value risk correctly. *Id.* See also Jane K. Winn, *Lien Stripping After Nobelman*, 27 LOY. L.A. L. REV. 541, 587 (1994) (citing lack of data support for repeated assertions of mortgage lenders that more generous lien stripping regime in bankruptcy will have calamitous effects on availability of mortgage credit). "Mortgage insurance, not deficiency liability, furnishes security for secondary market investors in shaky home mortgage markets." John Mixon & Ira B. Shepard, *Antideficiency Relief For Foreclosed Homeowners: ULSIA Section 511 (b)*, 27 WAKE FOREST L. REV. 455, 462 (1992). See also Philip Shuchman, *Data on the Durrett Controversy*, 9 CARDOZO L. REV. 605 (1987) (no correlation between high borrowing rates and greater consumer protection statutes).

⁶²⁸ "If the rule supported herein was otherwise, to the extent that a secured creditor was paid more than the real value of its lien, it would, in fact, be taking money from the limited pool of income available for distribution to all unsecured creditors. A requirement that undersecured mortgage creditors be paid in full would, in most cases, make it impossible to propose a feasible Chapter 13 plan to save a family home." See Position of the Commercial Law League of America, Hearing Before the Subcommittee on Courts and Administrative Practice of the Committee on the Judiciary, United States Senate, July 30, 1991.

A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

The need for statutory guidance on the valuation of collateral was a consistent theme throughout the Commission's hearings. On this basis, early versions of the Commission's consumer bankruptcy work contained a recommendation for a compromise valuation standard that would not entail a fact-intensive inquiry or require extensive litigation. Once it became clear that the Supreme Court would speak directly to the issue of valuation in *Associates Commercial Corp. v. Rash*, the Commission deferred further consideration of the precise standard to be recommended. In June of 1997, the Supreme Court issued a ruling in which it concluded that the relevant statutory provision, as it currently is written, requires a fact-intensive analysis.⁶²⁹ Having the benefit of the Court's interpretation, the Commission decided to revisit the underlying question of whether a statutory recommendation was in order to render this fact intensive analysis unnecessary. At the August 1997 meeting, the Commission discussed the *Rash* decision and concluded that a statutory amendment would be beneficial and directed that materials be prepared accordingly, which ultimately resulted in this Recommendation.

Chapter 13 permits a debtor to confirm a repayment plan over the objection of a secured creditor if the debtor pays the secured creditor the present value of its allowed secured claim, which is determined by the value of the collateral.⁶³⁰ The appropriate method to assess "value" is not clearly defined by the Bankruptcy Code and instead is left to case-by-case determination. Section 506(a), which is supposed to provide guidance, states as follows:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.*

Due to the flexibility inherent in this provision, the extent of the allowed secured claim may vary depending on the type of bankruptcy case, the type of property, and

⁶²⁹ 117 S.Ct. 1879 (1997).

⁶³⁰ See 11 U.S.C. § 1325(a)(5)(B) (1994).

the proposed disposition of the collateral.⁶³¹ Even in low-dollar-amount cases, therefore, there is no bright-line rule to give parties cheap and expedient answers to valuation questions. With the method to make this determination left completely undefined, courts have applied disparate methods to similar circumstances, yielding results ranging from the highest (*i.e.*, retail) to the lowest (*i.e.*, forced sale) possible valuations, with many options in between, including replacement cost, wholesale, and “midpoint” (the average of net resale proceeds and retail, a compromise method derived from Chapter 13 trustees).⁶³² Circuit courts of appeals have differed over the proper standard for determining the allowed secured claim.⁶³³ The announced standards have not always been clear, evidenced by the fact that judges reach conflicting interpretations of prior court decisions addressing valuation standards.⁶³⁴

⁶³¹ “‘Value’ does not necessarily contemplate forced sale or liquidation value of collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case.” H.R. REP. NO. 95-595 at 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6312.

⁶³² *See Stay Litigation After Rash, Our Two Cents*, <<http://www.stinson.com/2cents/rash.htm>> (which provides further delineation of potential valuation standards: “replacement cost (the current cost of a similar item); fair market value (what a willing buyer would pay for a like item sold by a willing seller); liquidation value (the estimated amount that could be realized from a forced sale of the property at a public auction after proper advertising); orderly liquidation value (the amount that could be realized from a forced sale of the property intact with all related equipment not necessarily at an auction); retail value (the price for which an item is sold at retail); wholesale value (the price for which an item is sold at wholesale); and going concern or enterprise value (the value of an enterprise as a going concern, taking into account goodwill).” Letter from Elliot D. Levin, *A Proposal for the National Bankruptcy Review Commission: The Fair Distribution of Value Created by the Bankruptcy Process Itself* to the National Bankruptcy Review Commission (undated) (listing various methods of valuation utilized: liquidation, fair value, fair market value, going concern value, and cash value (when property is sold)).

⁶³³ *Cf. In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (proper valuation was midpoint between wholesale and retail); *In re Rash*, 90 F.3d 1036 (th Cir. 1996) (en banc) (net foreclosure value), *rev’d*, 117 S.Ct. 1879 (1997); *Taffi v. United States*, 96 F.3d 1190 (9th Cir. 1996) (en banc) (fair market value for real property in individual Chapter 11 case), *cert. denied*, 117 S. Ct. 2748 (1997); *In re Trimble*, 50 F.3d 530 (8th Cir. 1995) (retail value of vehicle without deduction for costs of sale). *See also In re Valenti*, 105 F.3d 55, 62 (2nd Cir. 1997), (holding that it was within the bankruptcy court’s discretion to value at midpoint between wholesale and retail, but “no fixed value, whether it be retail, wholesale, or some combination of the two, should be imposed on every bankruptcy court conducting a § 506(a) valuation.”).

⁶³⁴ *See Associates Commercial Corp. v. Rash*, 90 F.3d 1036, 1060, 1062-63 (5th Cir. 1996) (en banc), (majority and dissenting decisions reaching differing conclusions on number of circuit courts that have held in favor of retail valuation), *rev’d*, 117 S.Ct. 1879 (1997).

To address a split in the circuits, the United States Supreme Court released a much-awaited decision on this issue, *Associates Commercial Corp. v. Rash*.⁶³⁵ *Rash* was a Chapter 13 case involving a tractor truck used by the debtor in his freight hauling business. In an *en banc* opinion reversing the initial appellate ruling that retail value determined the allowed secured claim, the United States Court of Appeals for the Fifth Circuit held that the valuation of a secured creditor's interest under section 506(a) "should start with what the creditor could realize if it repossessed and sold the collateral pursuant to its security agreement, taking into account the purpose of the valuation and the proposed distribution or use of the collateral."⁶³⁶ The court therefore determined that the bankruptcy court did not err when it valued the truck at wholesale; this price reflected the secured creditor's hypothetical yield had it repossessed and sold the truck.

The Supreme Court reversed and remanded the Fifth Circuit's *en banc* decision. The Supreme Court looked to the second sentence of that section 506(a), which requires a court to consider the proposed disposition or use of the property. The proper valuation standard if the collateral remained with the debtor, said the Supreme Court with only one dissenter, was replacement value less certain costs. Unlike other interpretations of the term "replacement value" that sometimes equate it with retail value, the Supreme Court's definition clearly requires deductions for certain costs, such as warranties, inventory costs, storage, and reconditioning. This would entail a fact-intensive analysis, with the actual method of determination to be left to individual judges.

The Supreme Court's adoption of a replacement-value-less-certain-costs standard reflected a deliberate policy choice. In footnote five, the Court stated that it sought to clarify the law. It "reject[ed] a ruleless approach allowing use of different valuation standards based on the facts and circumstances of individual cases." Notwithstanding the announced intent of this standard, the application of the standard is again fraught with ambiguity. In footnote six, the Supreme Court commented that the fact that the replacement value standard "governs in cramdown cases leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of property." The Supreme Court went on to describe the types of expenses that should be deducted to reach replacement value, each of which requires an independent determination. The variations based on the types of property and the expenses to be deducted make clear that a fact-intensive analysis and multiple valuations would be inevitable.

⁶³⁵ 117 S. Ct. 1879 (1994).

⁶³⁶ 90 F.3d 1036, 1060 (5th Cir. 1996) (*en banc*), *rev'd*, 117 S.Ct. 1879 (1997).

While the court uses the term “replacement value” that is sometimes associated with retail, the explanation of its calculation indicates a different, more complex valuation. Because the Supreme Court’s ruling was based on the interpretation of section 506(a), rather than on a more comprehensive policy judgment about what the appropriate valuation standard should be, the Commission recommends that Congress provide more guidance in this area to ensure that similar cases would be treated more equally and to reduce unnecessary litigation and transaction costs. The Commission’s Recommendation aims at a valuation based on fewer factors to be evaluated using a standard provable with relatively more ease.

Significance of Establishing a Standard to Determine the Allowed Secured Claim and the Problems with the “Replacement Value Less Certain Costs” Standard. Although the Supreme Court ruled in the context of a Chapter 13 cramdown, the standard for valuing the allowed secured claim has significant implications in all cases.⁶³⁷ Issues involving the valuation of property arise in almost every bankruptcy case, consumer or business.⁶³⁸ Valuation is central to adequate protection contests and to the plan confirmation process, and thus greatly affects negotiations in complex business reorganization cases.⁶³⁹ Although section 506(a) establishes that valuation is to be done on a case-by-case basis, the Supreme Court’s interpretation of section 506(a) calls into question the valuation standards heretofore used in all of these contexts.⁶⁴⁰

As a consequence of the approach taken by the Supreme Court majority, commentators fear that the *Rash* decision will exacerbate litigation on valuation issues. There are numerous practical difficulties of determining replacement

⁶³⁷ See, e.g., *In re Inter-City Beverage Co.*, 209 B.R. 931 (Bankr. W.D. Mo. 1997) (applying Supreme Court’s *Rash* decision outside context of Chapter 13 cramdown to value property sold in section 363 sale in Chapter 11 bankruptcy); *In re Pepper*, 210 B.R. 480 (Bankr. D. Col. 1997) (applying *Rash* to Chapter 7 case in determining whether lien impaired exemption under section 522).

⁶³⁸ “As Justice Stevens aptly points out in his dissent, section 506(a) is a ‘utility’ provision in that applies throughout the various chapters of the Code. This interpretation of the value of the secured claim also will apply to chapter 7, 11 and 12.” Robert F. Mitch, *The Rash Decision: A Question of Value*, AM. BANKR. INST. J., 18, 19 (July/Aug. 1997).

⁶³⁹ See generally Chaim J. Fortgang & Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061 (1985) (comprehensive review of valuation issues).

⁶⁴⁰ The Supreme Court’s decision in *Rash* potentially, although not definitively, calls into question all section 506(a) opinions interpreting the appropriate valuation standard. Some of these opinions are cited in this discussion not for their continuing precedential value, but rather to provide context or for their philosophical bases.

value,⁶⁴¹ particularly under the open-ended approach set forth in footnote six of the decision.⁶⁴² The inquiry entails many factual determinations regarding the amounts that must be deducted from the retail price. In many cases, the secured claim will be determined after a protracted “battle of the experts,”⁶⁴³ which can dissipate assets that otherwise would be available for distribution to other creditors.

A clearer standard that does not change from one factual setting to another is warranted to provide certainty and consistency for all valuation determinations. Simplicity is a prerequisite to any standard to be considered for adoption. A relatively simple standard reduces litigation costs while it increases the predictability of outcomes, permitting parties to settle their differences without always turning to the courts. A simple standard also promotes consistency in application among different judges and different districts, increasing the likelihood that similar cases will be analyzed using similar legal principles.

This Proposal recommends that the same baseline standards be employed for all valuation purposes. While the language of section 506(a) has been interpreted to permit—and perhaps mandate—different standards depending on the context of the valuation, it is not entirely clear why the same piece of property *should* be valued by various standards in multiple proceedings depending on the nature of each proceeding. Although valuation arises in a variety of legal contexts, the factual circumstances warranting valuation are limited: an estimate of valuation is required when the debtor plans to retain the property.⁶⁴⁴ There has been little explanation for why one valuation standard should be used for adequate protection and another for plan confirmation, one for determining the value of non-exempt property and another for the redemption of exempt property. Nor has there been an adequate argument made for why Chapter 13 valuations should be any different than

⁶⁴¹ See Hon. Frank H. Easterbrook, Bankruptcy Reform, Luncheon Address to the National Bankruptcy Review Commission Chicago Regional Hearing 4 (July 17, 1997) (“Replacement value cannot be looked up. It must be litigated; and in the process the value of the asset will be paid out to the lawyers rather than to the creditors.”).

⁶⁴² See Letter from G. Ray Warner, regarding the need establish statutory guidelines, at 1 (July 30, 1997) (noting that Supreme Court left to each bankruptcy court the proper method of determining value).

⁶⁴³ See Robert F. Mitch, *The Rash Decision: A Question of Value in Context*, AM. BANKR. INST. J. 18, 19 (July/Aug. 1997).

⁶⁴⁴ An estimate of value is not needed if the property is being sold. This is particularly true given the Commission’s Recommendation to clarify section 363(f) so that the value of the property is not relevant to the decision to sell free and clear. See Chapter 2 - Business Bankruptcy.

valuations in Chapter 11 or any other chapter.⁶⁴⁵ Without a clearly articulated principle to justify the propriety of various valuation standards in different procedural contexts, confusion is compounded with no offsetting gain.

The variety of applications of valuation standards demonstrate that no particular method can be deemed “pro-debtor” or “pro-creditor.” Depending on the circumstances, parties have different stakes in favoring a high or low valuation. For example, people might assume that the full “replacement value” standard is favorable to creditors. However, if the replacement value standard is used in automatic stay hearings, a court is more likely to find that the debtor has equity in the collateral and thus not lift the stay to permit the creditor to proceed with its rights against the property. Likewise, a creditor is less likely to be entitled to adequate protection payments using a high replacement value standard even though the creditor may not be fully protected in the event of a foreclosure if the reorganization effort fails.⁶⁴⁶ In such circumstances, high valuation can leave a secured creditor unprotected. Depending on the context, the valuation standard can yield quite different consequences.

In addition, no method of valuation is uniformly favorable to all creditors; the method of valuation that benefits a secured creditor in a particular situation is correspondingly less beneficial to unsecured creditors.⁶⁴⁷ This can be seen readily in the present Chapter 13 system, in which every dollar of “disposable income” must be made available to unsecured creditors. The smaller the secured claim of a lender, including interest payments, the larger the *pro rata* return to the unsecured

⁶⁴⁵ See *In re Hoskins*, 102 F.3d 313201 (7th Cir. 1996) (Easterbrook, J. concurring)(advocating that valuation rules be identical across chapters).

⁶⁴⁶ See Letter from G. Ray Warner, regarding the need establish statutory guidelines, at 1 (July 30, 1997) (noting that Supreme Court left to each bankruptcy court the proper method of determining value). See generally *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assoc.*, 484 U.S. 365, 371-72 (1988) (interpreting section 506(a) in considering creditors’ entitlement to adequate protection and determining that loss of right of immediate foreclosure is not factor to be considered in valuing creditor’s interest in collateral).

⁶⁴⁷ “If a bankruptcy court assigns a liquidation value to the collateral of secured creditors, it thereby awards the surplus to the unsecured creditors or to the debtor.” David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 2 (1996).

creditors.⁶⁴⁸ All parties have an important stake in the outcome of a valuation dispute.

Wholesale Price as a Compromise Bright-Line Standard. Among the spectrum of various options for valuation, from retail (highest value) to forced sale (lowest value), the Commission recommends that a price in the middle—wholesale price—be used to determine the allowed secured claim for personal property under section 506(a). This approach is supported by policy considerations and offers several advantages.

To start, many items of personal property have a readily identifiable wholesale price. Motor vehicles, an item of property frequently listed in consumer bankruptcies, will be one of the easiest to determine. Rather than working through “replacement value” and then calculating deductions for items such as warranties, inventory costs, advertising, storage, and reconditioning, wholesale value is readily ascertainable.⁶⁴⁹ The National Automobile Dealers Association (“NADA”) blue book is available throughout the country.⁶⁵⁰ Wholesale prices for other types of personal property in the consumer context, such as musical instruments, can be ascertained with relative ease. Wholesale price satisfies the first fundamental requirement for a bright-line rule—that it be workable—and thus helps to avoid transaction costs in bankruptcy.⁶⁵¹

⁶⁴⁸ *Rush*, 117 S.Ct. at 1387 (Stevens, J. dissenting) (“Allowing any more than the foreclosure value simply grants a general windfall to undersecured creditors at the expense of unsecured creditors”); *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (Easterbrook, J. concurring) (noting that retail valuation does not result in unjustified wealth transfer to debtors because valuation standard in Chapter 13, like Chapter 11, implicates only “relative stakes of secured and unsecured debts”). See also David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 79 (1991) (choice of determinative price depends on whether one believes that secured creditors or general creditors should receive the bonus associated with going concern; “logic alone cannot settle such questions in an uncontroversial manner”).

⁶⁴⁹ “Wholesale and retail values can be looked up in tables. They are simple to administer and satisfy my test for a good rule.” See Hon. Frank H. Easterbrook, *Bankruptcy Reform*, Luncheon Address to the National Bankruptcy Review Commission Chicago Regional Hearing 4 (July 17, 1997)

⁶⁵⁰ *In re Marshall*, 181 B.R. 599, 604 n.9 (Bankr. N.D. Ala. 1995) (NADA publication universally recognized as relevant and material evidence of value of used cars); *In re Johnson*, 165 B.R. 524, 529 (S.D. Ga. 1994) (NADA values are widely used in auto industry and courts to simplify and expedite valuation process); *In re Wierschem*, 152 B.R. 345, 347 (Bankr. M.D. Fla. 1993) (taking judicial notice of the NADA values).

⁶⁵¹ See, e.g., Hon. Edith H. Jones, *Recommendations for Reform of Consumer Bankruptcy Law* 18 (Aug. 6, 1997 draft) (recommending adoption of simple standard for valuing collateral).

Wholesale value can be calculated even when an item does not have a readily identifiable wholesale market by reference to a retail market for similar goods. Because the term “wholesale” triggers a distinction between old and new goods, it helps identify the proper market. The proper market is one that deals in goods of the kind to be valued—in their current state. In a consumer context, such property will nearly always be used, although in a business context, new or used property might be the correct valuation. For some consumer goods, a sale in the “want ads” or at garage sales or flea markets may be the only market for certain types of used goods. Since such markets are, by definition, not “retail” (and typically are not priced to include warranties and sales commissions), this is “wholesale.” No further calculation is needed. By making wholesale valuation the standard, in cases where no wholesale market exists, it would be possible to construct the price through a mechanism similar to that recommended in *Rash*, but with an easier application. Following the Supreme Court’s instructions in footnote six, a court likely would start with retail and subtract most costs that comprise the difference between the retail and wholesale prices.⁶⁵²

In addition, “compromise” is an element that many parties have sought in a valuation standard.⁶⁵³ Wholesale price provides a compromise between the lower valuations, such as resale price and foreclosure price, and the higher retail value.⁶⁵⁴

⁶⁵² See Hon. Frank H. Easterbrook, Bankruptcy Reform, Luncheon Address to the National Bankruptcy Review Commission Chicago Regional Hearing 5 (July 17, 1997) Examples of such costs offered by the Supreme Court included warranties, inventory, storage, reconditioning, and costs associated with modifications to the property that would not be subject to the creditor’s lien under state law. *Rash*, 117 S. Ct. at 1886, n.6.

⁶⁵³ *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (adopting midpoint valuation); *In re Valenti* 105 F.3d 55 (2nd Cir. 1997) (bankruptcy court did not err by upholding midpoint valuation).

⁶⁵⁴ Forced sale value should not be equated with wholesale value. *In re Taffi*, 68 F.3d 306, 308 (9th Cir. 1995), *aff’d en banc*, 96 F.3d 1190 (9th Cir. 1996). “Such sales are notoriously poor in producing cash proceeds.” David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 2 (1996). Forced sale prices tend not to adequately value property, and the failure to obtain the best price for collateral does not, by itself, permit a sale to be set aside as commercially unreasonable. U.C.C. § 9-507(2); *see, e.g.*, *Chavers v. Frazier*, 93 B.R. 366 (Bankr. M.D. Tenn. 1989) (airplane that was insured for \$700,000 sold at Article 9 sale for \$415,000). “The overlooked problem, of course is that ‘retail’ and ‘wholesale’ blue book prices have never been proxies for ‘replacement’ and ‘forced sale’ values. Wholesale value has never represented the amount that a creditor recovers after repossession and resale. Similarly, retail value has little to do with what a consumer would have to pay to buy a replacement automobile of like condition without a warranty from another consumer.” Gary Klein, *Opinion Raises More Questions Than it Answers*, AM. BANKR. INST. J. 18 (July/Aug. 1997).

Wholesale price can be viewed as a midpoint. However, because forced sales often yield so little, wholesale is often much closer to retail than to foreclosure.⁶⁵⁵

Another compromise that has been suggested is specifically denominated a “midpoint” valuation, a standard embraced by the Seventh Circuit Court of Appeals in *In re Hoskins* prior to the *Rash* decision.⁶⁵⁶ In *Hoskins*, the bankruptcy court had approved a valuation of the collateral that literally was the average of the highest and lowest values. Because the Chapter 13 trustee did not appeal the midpoint value on behalf of the unsecured creditors, foreclosure or wholesale values were not options before the Seventh Circuit. The midpoint valuation has the benefit of ensuring that neither the secured creditors nor the unsecured creditors reap a benefit at the complete expense of the each other. It avoids windfalls and neutralizes the strategic

⁶⁵⁵ Alvin C. Harrell, *UCC Article 9 Drafting Committee Considers October 1996 Draft*, 51 CONSUMER FINANCE L. Q. REP. (1997) (reporting that committee met to discuss low price foreclosure sales, among other issues); Donald J. Rapson, *Effects Treatment of Deficiency Claims: Gilmore Would have Repented*, 75 WASH. U.L.Q. 91 (1997) (urging adoption of rule deal with prevalent tendency for secured parties to file on collateral in foreclosure sales for far less than fair market value and then collect significant deficiency judgment). “[T]here is a positive incentive for [secured creditor] to buy at below the fair foreclosure value of the collateral. In all three cases, the actual “price” paid at the foreclosure sale is economically irrelevant to them except as it fixes the amount of deficiency. The lower the foreclosure sales price paid, the larger the deficiency which may be recovered from the debtor. And there is an opportunity for the secured party, recourse party, or related party to sell the collateral at a price which nets them more, sometimes substantially more, than the price they bid at the foreclosure sale.” Gail hildebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B, and 9 Be Fair to Consumers?*, 75 WASH. U.L.Q. 69, 133, 137 (1997) (noting continual problem of sales yielding values at far less than market price, citing studies of low disposition prices in consumer sales), citing David B. McMahon, *Commercially Reasonable Sales and Deficiency Judgments Under UCC Article 9: An Analysis of Revision Proposals*, 48 CONSUMER FIN. L.J. REP. 64 (1994); *Armstrong v. Csurilla*, 817 P.2d 1221 (N.M. 1991) (discussing low prices that foreclosure sales often bring and when they can be deemed inadequate). “[T]he only bidder at 99% of foreclosure sales is the mortgagee ... State foreclosure laws have failed to adequately protect the debtor from low sales prices. The statutory notice requirements generate little interest and most mortgagees have little incentive to advertise.” Robert Burford, *Can Mortgage Foreclosure Sales Really be Fraudulent Conveyances Under Section 548(a)(2) of the Bankruptcy Code?*, 22 HOUS. L. REV. 1221, 1248 (1985). Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 320-21, n.52 (sales procedures used by bankruptcy courts are “vastly superior to those employed in the state remedies subsystem”). But see *Rash*, 90 F.3d at 1052, n.20 (secured creditor presented testimony that it regularly received 92% of retail price for its trucks at foreclosure sales).

⁶⁵⁶ *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (average of wholesale and retail value).

power that either set of creditors would enjoy under the alternative rules.⁶⁵⁷ For this reason, some districts have adopted the midpoint valuation by local rule.⁶⁵⁸

A wholesale valuation accomplishes much of the same goals because it permits the parties to share in the benefit of the reorganization. A compromise approach is consistent with the notion that the chosen valuation standard should not create perverse incentives to use bankruptcy strategically. If creditors can count on property valuations well in excess of the creditors' state law entitlements, then they have an incentive to push for bankruptcy rather than out-of-court workouts. At the same time, if property valuations in bankruptcy will be far below what the debtor could yield by selling the property, the debtor can use bankruptcy to extract value from creditors in ways that are not consistent with bankruptcy principles. A clear standard pegged at a compromise point is most likely to keep strategic maneuvering by either party to a minimum.

While "wholesale" and "midpoint" might be similar to each other in many cases, using "wholesale" valuation has clear advantages. Unlike the "midpoint" compromise which requires two separate valuations, wholesale valuation requires the identification of only one price. Certainty increases as administrative costs decrease with a wholesale valuation.

An important policy consideration underlies adoption of a wholesale valuation. Quite significantly, adoption of a wholesale valuation ensures that a creditor's secured claim will cover at least what the creditor would have received under state law. This standard properly defines property rights in the absence of an overriding bankruptcy policy.⁶⁵⁹ The Uniform Commercial Code entitles a secured creditor to seize and sell the collateral in a commercially reasonable fashion, such as an auction.⁶⁶⁰ If the creditor is entitled to a higher replacement cost or retail, the creditor has a larger entitlement than if the debtor surrendered the property, without having to incur the expenses necessary to fetch a retail price. Choosing wholesale protects secured creditors at least for the resale price, which some argue is the most

⁶⁵⁷ *Id.* at 315 (people who find themselves in a bilateral monopoly situation will often agree simply to split the difference).

⁶⁵⁸ See, e.g., *In re Valenti*, 105 F.3d 55, 58 (2d Cir. 1997) (considering N.D.N.Y. Local Bankr. R.); *In re Sharon*, 200 B.R. 181, 195 (Bankr. S.D. Ohio 1996).

⁶⁵⁹ *Butner v. United States*, 440 U.S. 48 (1979); *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996) (Easterbrook, J. concurring). *Associates Commercial Corp. v. Rash*, 90 F.3d 1036, 1042, (5th Cir. 1996) (en banc) (if creditor is entitled to replacement cost, would modify extent to which creditor is secured under state law), *rev'd on other grounds*, 117 S. Ct. 1879 (1997).

⁶⁶⁰ U.C.C. §§ 9-502 - 9-505.

accurate reflection of state law entitlements.⁶⁶¹ Of course, in a limited-asset system such as bankruptcy, what is guaranteed to any one creditor is taken from other parties. Wholesale valuation, because it is typically higher than foreclosure or repossession valuation, potentially provides secured creditors with more than they would receive under non-bankruptcy law. By looking to wholesale price, a secured creditor should be protected at least for “the equivalent of recourse to the collateral,”⁶⁶² when the creditor gets, in effect, its best price.

The wholesale standard also is fair to debtors. A debtor who retains collateral will have to pay more than liquidation value on the allowed secured claim, but the debtor has the opportunity to keep the property, an option not available to the debtor outside bankruptcy. Thus, the debtor also receives a benefit it would not have received if the property had been repossessed under state law.

No valuation standard can be wholly satisfactory to all parties. The zero-sum game of many bankruptcy decisions necessarily reveals itself somewhere. Using wholesale valuation, the unsecured creditors may be the losers as compared to what they could have received if foreclosure value was adopted. This is particularly true under the current “disposable income” requirement that determines unsecured creditor distributions in Chapter 13 based in part on what is left over after paying secured creditors. While the Commission’s Recommendation to replace the Chapter 13 disposable income requirement with a flat percentage would de-link valuation from unsecured creditor returns to a certain extent, it still is clear that the wholesale standard is less advantageous to unsecured creditors than a foreclosure sale standard. At the same time, wholesale is less likely to cut unsecured creditors out completely than the higher retail standard.

However, the wholesale standard should promote overall economic efficiency. The purpose of collateral is to serve as a source of payment for a loan in the event that the borrower defaults. Providing at least the value that a creditor could

⁶⁶¹ *Rash*, 90 F.3d at 1042, *rev’d.*, 117 S. Ct. 1879 (1997); *In re Hoskins*, 102 F.3d 311 (Easterbrook, J. concurring). “If the debtor must pay the secured creditor the retail value of the collateral in order to retain the collateral under Section 1325(a)(5)(B), the apparent congruence of protection afforded by Sections 1325(a)(5)(B) and (C) [providing option to surrender collateral] would be lost.” *In re Maddox*, 200 B.R. 546, 553 (D.N.J. 1996) (affirming bankruptcy court’s application of wholesale value to vehicles to be retained in Chapter 13).

⁶⁶² S. Andrew Bowman & William M. Thompson, *Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection*, 15 IND. L. REV. 569, 577 (1982), *cited in Rash*, 90 F.3d at 1047, *rev’d.*, 117 S. Ct. 1879 (1997). “A debtor may cram down a plan either by abandoning the collateral to the secured party (so that a foreclosure sale can occur under state law), or by retaining the collateral but distributing legal rights with a comparable value to the secured creditor. These two cram down options should be the same, from the perspective of the secured creditor.” David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 8-9 (1996).

realize following repossession and resale of that particular collateral reflects that purpose. If a high valuation relative to the actual value precludes the confirmation of a feasible plan, a debtor will forfeit the collateral to a creditor that will receive only the much lower foreclosure price upon repossession and foreclosure. Thus, a higher valuation standard would force the transfer of property to a party that would yield a lower return for it. Wholesale valuation may be more economically efficient because the debtor will be able to keep the property in those cases where the debtor values it most.⁶⁶³

When determining how to calculate the allowed secured claim, it also is important to recognize the goal of the valuation exercise: an accurate valuation of the asset to capture the present value of the asset's future cash flows. Wholesale price is a much better approximation of the collateral's actual value because retail price reflects an extra component of a retailer's value-adding attributes that are not relevant or appropriate in this context, especially when the secured creditor is not a retailer itself.⁶⁶⁴ Even when the secured creditor is a retailer, there are very real expenses that the creditor must expend to resell an item for a retail price. The Supreme Court seemed to recognize this underlying economic reality in footnote six of its decision in *Rash*, and the Commission's Recommendation reflects this reality as well.

Fair Market Value Minus Hypothetical Costs of Sale. In valuing real property, fair market value minus hypothetical costs of sale provides a parallel

⁶⁶³ “[T]he highest valuing user enjoys the rest of the value as consumer surplus. . . . That is what bankruptcy valuation is supposed to replicate, and the use of wholesale price does the job.” *In re Hoskins*, 102 F.3d 311, 320 (7th Cir. 1996) (Easterbrook, J. concurring).

⁶⁶⁴ “The distinction between wholesale and retail prices is a false one. Retail prices reflect value added by the retailer. If the cost of value added by the retailer were to be removed from retail value, the remainder would be wholesale value. Hence, wholesale is simply retail minus the transaction costs of retailing . . . these transaction costs ought to be removed. David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 8 (1996) “The retailer adds value to the transaction. The retailer maintains an inventory of automobiles, reducing the number of sites a buyer must visit to complete a transaction and thereby reducing the buyer's search costs. The retailer, like the securities dealer, also stands ready to buy and sell automobiles, thereby providing liquidity to the marketplace. A retailer also may provide explicit or implicit certifications of quality, perhaps through the retailer's reputation in the community.” Robert M. Lawless & Stephen P. Ferris, *Economics and the Rhetoric of Valuation*, 5 J. BANKR. L. & P. 3, 16-18 (1995) (“We believe that a value that approximates wholesale price should be the relevant measure of [lender]'s claim for purposes of the Chapter 13 cramdown Because the value of an automobile sold in the market at the wholesale level comes almost directly from the manufacturing activities of the dealer, the wholesale price of the automobile likely comes closest to representing the automobile's true worth”).

standard.⁶⁶⁵ A number of circuit courts of appeals have adopted the fair market value standard for assessing the allowed secured claim on real property.⁶⁶⁶ The proposed approach diverges from those court decisions in that they have not deducted hypothetical costs of sale. Refusing to deduct hypothetical costs generally has been justified by the same arguments employed to support retail valuation of personal property: because these courts focus on the debtors' intended use of the property, *e.g.*, continued possession, they have found that it would be unreasonable to deduct costs when no sale is intended. Other courts sharply disagree with this premise; they instead base their inquiries on the creditor's interest in the property and note that a secured creditor could never realize fair market value without incurring disposition costs, and thus these must be factored into the valuation.⁶⁶⁷

The Recommendation proposes deducting sales costs from the fair market price for several reasons. A fair market value standard properly sets the allowed secured claim at an amount that represents what a willing and fully informed buyer would pay under fair market conditions. It is the best approximation of the property's market value and reflects that there is less difference for real property between the price that a debtor and the price another party could obtain for the property outside the context of a foreclosure sale. Typically, there is no wholesale market for real estate. A wholesale approach to real estate, therefore, is "retail" less expenses, as *Rash* generally establishes.

Fair market value less costs also is a good compromise. Fair market value less costs of sale is higher than a foreclosure or forced sale price, but only slightly less than a non-adjusted fair market price, assuming that a foreclosure sale price often is lower than fair market value.⁶⁶⁸ To that extent it provides a reasonably

⁶⁶⁵ This standard would not apply to mortgages on the primary residence of a Chapter 11 or 13 debtor retaining the residence when such mortgages are protected from modification. This standard presumably would apply, however, to personal property forms of holding real property, such as land trusts.

⁶⁶⁶ *See, e.g.*, *Taffi v. United States*, 96 F.3d 1190 (9th Cir. 1996) (en banc), *cert. denied*, 117 S. Ct. 2748 (1997); *In re Trimble*, 50 F.3d 530 (8th Cir. 1995); *Winthrop Old Farm Nurseries v. New Bedford Institution for Savings*, 50 F.3d 72 (1st Cir. 1995); *In re McClurkin*, 31 F.3d 401, 405 (6th Cir.1994). *Cf. In re Balbus*, 933 F.2d 246, 250-52 (4th Cir.1991) (where purpose of valuation was to determine whether debtor had too much unsecured credit to qualify as Chapter 13 debtor, and where debtor would retain house under plan, value of creditor's interest in house was amount creditor would receive at foreclosure sale).

⁶⁶⁷ *See, e.g.*, *Bank of Am., Ill. v. 203 N. LaSalle St. Partnership*, 195 B.R. 692 (N.D. Ill. 1996) (valuing real property at its fair market value but deducting disposition costs), *aff'g*, 190 B.R. 567 (Bankr. N.D. Ill. 1995), *aff'd*, No. 96-2137 & 96-2138 (slip. op.) (7th Cir. Sept. 29, 1996).

⁶⁶⁸ The Supreme Court held in *BFP v. Resolution Trust Corp.*, 511 U.S. 53 (1994) that a noncollusive foreclosure sale price would be reasonably equivalent value for purposes of

parallel approach to the wholesale standard, again offering a “compromise” valuation method that is easier to administer than another midpoint standard that would require two valuations.

Deducting costs of sale also better reflects a secured creditor’s state law entitlement, which must be considered in this type of analysis.⁶⁶⁹ If the secured creditor foreclosed and exercised its state law remedies, its return would be far less than fair market value without cost adjustments.

In addition, section 506(c), which permits costs of sale to be surcharged against a secured creditor’s collateral, supports the notion that costs of sale can lower the return and, thus, the ultimate value to a secured creditor.⁶⁷⁰ If the price received does not cover the costs of sale plus the full amount of the loan, the secured creditor’s recovery is reduced, and the secured creditor’s claim is bifurcated into its secured and unsecured portions. On the other hand, if the price received for the property is sufficient to cover both the costs of sale and the secured claim, then the secured creditor is protected in full. The Recommendation puts the secured creditor whose collateral is retained in the same position as the secured creditor whose collateral is sold.

A balance between secured and unsecured creditors is more fully established when the allowed amount of creditor’s secured claim is adjusted for the costs it did not have to incur to be protected for the fair market price. Again, this permits all parties to participate and share in the benefits of the reorganization. However, the parties who gain may be shortchanged by a fair market valuation are the unsecured creditors, who more likely would yield a greater return with a foreclosure sale valuation standard.

Competing Considerations. Some would criticize the wholesale and fair market less cost standards as being too high. These standards, it has been argued, provide a windfall to secured creditors that bargained for and would receive only foreclosure value outside bankruptcy, where they also would have to bear the costs and burdens attendant to those collection activities. The high valuation used here is contrary to a policy of encouraging debtors to file for Chapter 13 and makes it more difficult for them to confirm plans and to complete their repayment obligations. To the extent that distributions to unsecured creditors depend on valuation of collateral, the interests of unsecured creditors are harmed by these higher valuation standards.

determining whether the sale was a fraudulent conveyance. However, reasonably equivalent value does not equate with fair market value.

⁶⁶⁹ See *Butner v. United States*, 440 U.S. 48 (1979).

⁶⁷⁰ David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 51 (1996).

Perhaps reflecting the compromise nature of this approach, the recommended valuation standard also has been criticized for being too low. Some argue that wholesale valuation permits the debtor to obtain a windfall in the event that the debtor resold the property for retail price.⁶⁷¹ Of course, this argument has little applicability in the context of most consumer cases or in any case in which the debtor is not in the business of selling that particular type of collateral. The debtor is ill-equipped to take the steps that add the requisite value that would be necessary to fetch a retail price, such as providing a warranty, reconditioning the property, offering credit terms, or being well located in a shopping area.⁶⁷² More significantly, this circumstance is economically unlikely in a competitive market, according to some scholars and economists: “[i]f such opportunities did exist, we would expect to see persons enter the market to take advantage of them. These new market entrants would bid up the wholesale price until it eventually equaled the retail price.”⁶⁷³ The reason a difference exists between wholesale and retail, they explain, is that value is added at the retail level.

Some have argued that a different policy issue should be reflected in the valuation standard. They argue that property valuation should be sufficiently high to offset the risk of loss to the creditor. According to this argument, valuation should be high because it may be inaccurate or because the value may decline. However, risk can be addressed through other means. Compensation for risk of loss can be accomplished in ways such as adjustment of the amortization rate, adjustment of the interest rate, calculation of adequate protection payments, or changes in other terms of the agreement. By using these devices, the question of risk is squarely presented, not buried in a broad rule of valuation. The Bankruptcy Code’s current approach is more accurate because it is based on actual risk, not a universally-presumed risk incorporated into a valuation standard applicable to all debtors and all situations.

⁶⁷¹ *Associates Commercial Corp. v. Rash*, 31, F.3d 325 (5th Cir. 1994), *rev’d on rehearing en banc*, 90 F.3d 1036 (1996), *rev’d*, 117 S. Ct. 1879 (1997).

⁶⁷² Robert M. Lawless & Stephen P. Ferris, *Economics and the Rhetoric of Valuation*, 5 J. BANKR. L. & PRAC. 3, 18 (1995) (consumer debtor, as one-time dealer, cannot provide services to marketplace that would permit her to charge higher retail price).

⁶⁷³ *Id.* at 5.

1.5.3 Payments on secured debts that are subject to modification should be spread over the life of the plan, according to fixed criteria for interest rates.

Interest Rate

Closely related to the question of valuation is the issue of interest rates to be paid on secured claims, an issue not resolved in *Rash*. A secured creditor is entitled to the present value of its allowed secured claim, but section 1325(a)(5)(B)(ii) does not specify what interest rate will give a creditor “present value.” During the legislative process leading to the Bankruptcy Amendments and Federal Judgeship Act of 1984, Congress specifically considered, but rejected, an amendment that would have required that interest be paid at the contract rate.⁶⁷⁴ The absence of statutory authority has led courts to employ different methods to determine the appropriate rate of interest. Some districts have adopted local rules to deal with applicable interest rates payable in bankruptcy. This is a subject on which there is circuit court authority, but the circuits have settled on different legal rules. In short, the variety of opinions and authorities using different interest rates to determine “present value” has multiplied many times since the adoption of the 1978 Code.

Some courts endorse the use of a market rate of interest and have found that the nondefault contract rate presumptively is the market rate absent evidence to the contrary.⁶⁷⁵ According to this view, the objective of section 1325(a)(5)(B)(ii) is to put the creditor in the same economic position as if it received the value of its allowed claim immediately. Sometimes called the “forced loan” rule, this approach bases the section 1325(a)(5)(B)(ii) interest rate what the creditor charges for loans of similar character, amount, and duration to debtors in the same geographic region.⁶⁷⁶ Because Chapter 13 cases involve small dollar amounts that could be consumed in litigation

⁶⁷⁴ H.R. 1085, 98th Cong., 1st Sess. § 19(2)(A) (1983); H.R. 1169, 98th Cong., 1st Sess. § 19(2)(A) (1983); H.R. 4786, 97th Cong., § 19(2)(A) (1981). *See generally* Key Bank of N.Y. v. Harko, 211 B.R. 116 n.7 (B.A.P. 2nd Cir. 1997).

⁶⁷⁵ *See, e.g.*, Green Tree Fin. Serv. Corp. v. Smithwick, 121 F.3d 211 (5th Cir. 1997) (reversing and remanding bankruptcy court application of interest rate by local rule and holding that contract interest rate is presumptively appropriate cramdown rate unless debtor comes forward with evidence showing that creditor’s current rate is less); General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 65 (3d Cir. 1993).

⁶⁷⁶ United Carolina Bank v. Hall, 993 F.2d 1126, 1130-31 (4th Cir. 1993) (match rate of return to secured creditor with what creditor otherwise would obtain in its lending market); *In re* Hardzog, 901 F.2d 858, 860 (10th Cir. 1990) (in Chapter 12 case, market of similar loans in the area utilized); Memphis Bank and Trust Co., v. Whitman, 692 F.2d 427, 431 (6th Cir. 1982) (same).

expenses if the rules are too complicated, courts taking this approach may presume that the contract rate is the market rate.⁶⁷⁷

Other courts use a different market rate, the “cost of funds” to the creditor. Thus, the rate that should be paid is what the creditor pays to borrow funds. According to this view, assuming that the creditor would borrow the money representing the value of its allowed claim is the best way to put a creditor in the same economic position as if the debtor surrendered the collateral immediately. The creditor then could make new loans to consumers at prevailing rates in the commercial market.⁶⁷⁸ The proponents of the approach believe that the forced loan rate used by other courts contains an element of profit that should not be included in the cramdown interest rate, lest the creditor receive more than the present value of its allowed claim.⁶⁷⁹ They argue that courts should not award profit, administration costs, risk, industry transactional costs, costs of collection, and the other extra elements that go into a contract interest rate.⁶⁸⁰

A third method employs the cost of funds approach, but also attempts to reconcile the fact that it provides nonuniform treatment to Chapter 13 debtors. This consideration led the Second Circuit to hold that the market rate of interest under section 1325(a)(5)(B)(ii) should be fixed at the prevailing rate of a United States Treasury instrument with a maturity equivalent to the repayment schedule under the debtor’s reorganization plan.⁶⁸¹ Because the rate on a treasury bond is virtually

⁶⁷⁷ See, e.g., *Green Tree Fin. Serv. Corp. v. Smithwick*, 121 F.3d 211 (5th Cir. 1997); *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 65 (3d Cir. 1993).

⁶⁷⁸ See *United Carolina Bank v. Hall*, 993 F.2d at 1130; *United States v. Doud*, 869 F.2d 1144, 1145-46 (8th Cir. 1989); *Koopmans v. Farm Credit Servs.*, 196 B.R. 425, 427 (N.D. Ind.), *aff’d*, 102 F.3d 874 (7th Cir. 1996).

⁶⁷⁹ See, e.g., *In re Hudock*, 124 B.R. 532, 534 (Bankr. N.D. Ill. 1991) (“The Bankruptcy Code protects the creditor’s interest in the property, not the creditor’s interest in the profit it had hoped to make on the loan.”); *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 939 (Bankr. S.D.N.Y. 1994); see generally Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 THUR. MARSH. L. REV. 241 (1994).

⁶⁸⁰ *Shearson Lehman Mortgage Corp. v. Laguna*, 944 F.2d 542 (9th Cir. 1991), *cert. denied*, 503 U.S. 966 (1992).

⁶⁸¹ “This method of calculating interest is preferable to either the “cost of funds” approach or the “forced loan” approach because it is easy to apply, it is objective, and it will lead to uniform results. In addition, the treasury rate is responsive to market conditions.” *In re Valenti*, 105 F.3d 55, 64 (2d Cir. 1997) (reversing lower court determination that 9% market rate applied to cramdown interest payments), *citing* *Heartland Fed. Sav. & Loan Ass’n v. Briscoe Enters.*, 994 F.2d 1160, 1169 (5th Cir. 1993); *Doud*, 869 F.2d at 1145-46; *In re Dingley*, 189 B.R. at 271; *In re Smith*, 178 B.R. at 953; *In re Wynnefield Manor Assocs., L.P.*, 163 B.R. 53, 60 (Bankr. E.D. Pa. 1993).

risk-free, the court also found that the cramdown interest rate should include a premium to reflect the risk that the creditor bears in receiving deferred payments under the reorganization plan.⁶⁸² The Second Circuit held that a risk premium should be added to the prevailing interest rate, suggesting that a premium of 1-3% would be appropriate, but left the ultimate determination to the discretion of the bankruptcy judge.

Most agree that the Chapter 13 system should supply a uniform rule. The uncertainty regarding the proper interest rate has two negative consequences. First, debtors appearing before one judge may be required to pay a significantly lower rate of interest than debtors appearing before other judges even when both the debts and the risks are virtually identical. Aside from yielding different returns to secured creditors, this section yields diverse distributions to similarly situated unsecured creditors as well, for in the current Chapter 13 system, the amount of money allocated to interest payments on secured debt is deducted directly from the amount that otherwise would be available for distribution to unsecured creditors. The uncertainty over interest rates also causes unnecessary litigation when money is scarce, further reducing both the debtor's ability to confirm a plan and the creditors' ultimate recovery. In many cases, the costs of litigation over interest rates would more than exceed the amount at stake. Most people therefore agree that the Code should clarify the proper Chapter 13 plan interest rate.

The Commission recommends that the rate of interest should be determined using a nationally recognized rate to promote the equal treatment of similarly situated debtors and creditors. The Commission does not recommend a particular rate. Its previous discussions have referred to the six-month treasury bills rate as a starting point, with additional points added thereto for a risk premium.

With respect to the cure of a default on any debt pursuant to a plan, including mortgage debt, interest under section 1322(e) would run at the nondefault contract rate. Section 1322(e) was added to the Code by the Bankruptcy Reform Act of 1994 to overrule the result reached by the Supreme Court in *Rake v. Wade*.⁶⁸³ *Rake* had held that a Chapter 13 debtor must pay interest on a mortgage arrearage as a condition of cure and reinstatement, even if the mortgage contract had not so required. Because the debtor effectively would have to pay interest on interest, it provided a windfall to secured creditors that they would not have received if the debtor had not filed for bankruptcy. *Rake* thus worked to the detriment of unsecured

⁶⁸² *Valenti*, 105 F.3d at 55, citing *Farm Credit Bank v. Fowler (In re Fowler)*, 903 F.2d 694, 697-98 (9th Cir. 1990); *Koopmans v. Farm Credit Servs.*, 196 B.R. 425, 427 (N.D. Ind.), *aff'd*, 102 F.3d 874 (7th Cir. 1996); *In re Dingley*, 189 B.R. at 271 (citations omitted); *In re Cellular*, 171 B.R. at 940.

⁶⁸³ 113 S. Ct. 2187 (1993).

creditors by reducing the distribution available to them. Section 1322(e) requires that the amount necessary to cure a default must be determined in accordance with the underlying agreement and applicable nonbankruptcy law. This rule was intended to put the debtor in the same position as if the default had never occurred.⁶⁸⁴

Competing Considerations. A rule providing for interest at the nondefault contract rate also would be easy to apply. This rate would bind the debtors to their original bargains to the extent possible. Moreover, it arguably represents a fair proxy for general market rates of interest applicable to the collateral at issue.⁶⁸⁵ Such an interest rate arguably includes a calculation for profit, potentially giving the creditor more than it would have received had the property been foreclosed. The contract rate also does not provide the same consistency that could be obtained through the use of a uniform rate. A Chapter 13 payment plan involves different and broader considerations than were contemplated in the bilateral contract between the debtor and one creditor. Distributions to a secured creditor based on interest payments reduce the resources available to pay unsecured creditors, who typically do not receive full payment of the underlying debt and who almost never receive any interest payments.

Secured Debt Payments Spread Over Life of Plan

Under the current system, payments to secured creditors frequently are made at the beginning of the plan. This provides a quicker cure for defaults, but it has corollary consequences. It delays payments to unsecured creditors for several years. Furthermore, because a debtor can cure an arrearage on a secured loan and dismiss the case, unsecured creditors may never get paid at all. Included among the unsecured creditors who do not receive a *pro rata* distribution are the secured creditors whose liens were stripped to the value of the collateral.

The Commission recommends that payments to secured creditors be spread over the life of the plan concurrently with *pro rata* distributions to unsecured creditors, also spread over the life of the plan. Because debtors would not be able to front load their cure payments and dismiss the plan, this method would increase the likelihood of a higher number of distributions to unsecured creditors and would enhance the probability that debtors will stay in their plans for the full term.

This approach is not without its risks. Stretching out payments and requiring concurrent secured and unsecured payments may increase the risk of plan failure and heighten the consequences of failure to the debtor, such as the loss of a car. It is possible that other types of changes, such as restrictions on entitlements in serial

⁶⁸⁴ 140 Cong. Rec. H10,769 (daily ed. Oct. 4, 1994).

⁶⁸⁵ General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 65 (3d Cir. 1993).

cases, are more suitable methods to address alleged misuse of Chapter 13 without increasing the likelihood of failure for other debtors.

At the same time, some might argue that this procedure might not protect creditors sufficiently, especially if the debtor had only a few more payments when filing for bankruptcy. A too-low uniform interest rate may not protect creditors' interests adequately if payments are extended through the full plan term.

1.5.4 *Unsecured Debt*

Payments on unsecured debt should be determined by guidelines based on a graduated percentage of the debtor's income, subject to upward adjustment to meet the section 1325(a)(4) requirement that creditors receive at least the present value of whatever they would have received in a Chapter 7. The trustee or an unsecured creditor should be authorized to file an objection to any plan that deviated from the guidelines, and a court would determine whether the deviation was appropriate in light of all the circumstances.

Under current law, payments to unsecured creditors are generally determined by the "disposable income requirement." Section 1325 of the Bankruptcy Code provides that a court can confirm a Chapter 13 plan over the objection of the trustee or a creditor if the debtor commits three years' worth of "disposable income" to paying unsecured creditors under the plan.⁶⁸⁶ This concept was introduced into the Chapter 13 system by the Consumer Credit Amendments in 1984.⁶⁸⁷

The disposable income approach has facial appeal to both creditors and debtors, albeit for different reasons. Being entitled to all disposable income connotes to unsecured creditors that they will receive every extra penny of income for several years, creating the inference that Chapter 13 is a successful repayment mechanism. For debtors, the fact that the unsecured debt payment is keyed to disposable income signifies that they will not be shut out of Chapter 13—even if they are unable to make substantial payment—as long as they agree to contribute whatever income they have left after paying all of their other expenses. Neither of these connotations of the disposable income has borne out fully in reality. While the disposable income approach enjoys support across various segments of the bankruptcy community, it has some significant shortcomings in practice that should be brought to light.

⁶⁸⁶ 11 U.S.C. § 1325(b) (1994).

⁶⁸⁷ Bankruptcy Amendments and Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

Calculating the “disposable” portion of the debtor’s income starts with the inherently subjective scrutiny of the expenses that the debtor insists are necessary. To the extent that debtors completely encumber their income with expenses that are considered “reasonably necessary,” they have no disposable income at all. Consequently, if their plans are confirmed, their unsecured creditors receive nothing. Conversely, if a court does not share a debtor’s view of reasonable expenses and recalculates the debtor’s disposable income to be a higher amount, the plan will not be confirmed unless the debtor agrees to make other sacrifices to make that amount available.

Courts take different approaches to overseeing satisfaction of the disposable income requirement. Some courts or trustees conduct only a limited review of debtors’ budget and scrutinize only luxury items while other courts take on the role of an “itemized examiner.”⁶⁸⁸ Under any approach, however, it is all too clear that after thirteen years’ experience with the disposable income requirement, courts seem no closer to sharing a collective view of what constitutes “reasonably necessary expenses” than they were at the inception. Some courts believe that private schools are necessary, while others do not.⁶⁸⁹ Orthodontia, piano lessons, college tuition,⁶⁹⁰ home repairs, dry cleaning, newspapers,⁶⁹¹ tithing,⁶⁹² utility payments, and food

⁶⁸⁸ See Kathleen A. Laughlin, *A Chapter 13 Trustee’s Guidelines for Determining Disposable Income: A Task that Would Give a Woodpecker a Headache*, 13 NAT’L ASS’N CH. 13 TRUSTEES Q. 13 (Jan. 1994). See also Comment, *Reasonably Necessary Expenses or Life of Riley? The Disposable Income Test and Chapter 13 Debtor’s Lifestyle*, 56 MO. L. REV. 617, 632 (1992).

⁶⁸⁹ *In re Jones*, 55 B.R. 462, 466-67 (Bankr. D. Minn. 1985) (private school tuition objectionable).

⁶⁹⁰ See, e.g., *In re Gonzales*, 157 B.R. 604, 607-09 (Bankr. E.D. Mich. 1993) (finding educational expenses for masters program discretionary and thus not reasonably necessary); *In re Jones*, 55 Bankr. 462, 466-67 (Bankr. D. Minn. 1985) (college tuition payments objectionable); *In re Jolly*, 13 B.R. 123, 125 (Bankr. E.D. Wis. 1981) (pre-disposable income case holding under good faith standard that money saved for children’s education should be available to creditors).

⁶⁹¹ See, e.g., *In re Fields*, 190 B.R. 16, 18-19 (Bankr. D.N.H. 1995) (confirming discretionary expenses for family of five of \$145 per month to cover cost of newspapers, birthday presents, and other discretionary items).

⁶⁹² Compare *In re Tessier*, 190 B.R. 396, 403 (Bankr. D. Mont. 1995) (plan not confirmable because tithing not reasonably necessary, so falls within disposable income) with *In re Bien*, 95 B.R. 281, 282 (Bankr. D. Conn. 1989) (tithe was reasonably necessary expenditure); *In re Cavanagh*, 175 B.R. 369, 374-75 (Bankr. D. Idaho 1994) (tithing not reasonably necessary, but within discretionary spending); *In re Green*, 73 B.R. 893, 893 (Bankr. W.D. Mich. 1987) (court would violate First Amendment by denying confirmation of Chapter 13 plan based on declared intention to make tithing to church), *aff’d*, 103 B.R. 852 (W.D. Mich. 1988); *In re McDaniel*, 126 B.R. 782 (Bankr. D. Minn. 1991) (finding a proposed monthly tithe of \$540.00 excessive). See generally Note, *Tithing in Chapter 13 - A Divine Creditor Exception To Section 1325?* 110 HARV. L. REV. 1125, 1142 (1997)

allocations are just a few of the expenses that are scrutinized in this context. Personal views of what is and what is not necessary for a family inescapably factor into the equation. The amount that debtors must pay to their unsecured creditors will differ from courtroom to courtroom not because of different circumstances, but because of divergent views on the expenses perceived to be reasonably necessary.⁶⁹³ Because the inquiry is so fact-specific and non-legal, published opinions have little precedential value. Any party can threaten to litigate, knowing that there is some case law to support any position. The confusion over standards increases the leverage of any party with the resources and the stamina to fight about disposable income.

The wide variability in Chapter 13 practices make it difficult for unsecured creditors to monitor cases for proposed debt repayments. With only *pro rata* distribution as a reward, challenging a proposed repayment plan is not a sound financial strategy when the courts have no predictable rules about the amount they will require the debtor to pay.⁶⁹⁴

The “disposable income” concept also is at odds with other goals of the Chapter 13 system. Difficulties in budgeting and managing finances were partly

(Establishment Clause mandates refusal to recognize tithing; “were the bankruptcy courts to shift course by exempting tithes from the section 1325(b) disposable income test, they would impermissibly favor religious interests over nonreligious interests.”) *But see* Carol Koenig, *To Tithe or Not to Tithe: The Constitutionality of Tithing in a Chapter 13 Bankruptcy Budget*, 32 SANTA CLARA L. REV. 1231, 1241-57 (1992); Bruce E. Kosub & Susan K. Thompson, *The Religious Debtor’s Contribution to Tithes at the Price of a Chapter 13 Discharge*, 66 TEX. L. REV. 873, 892-903 (1988); Oliver B. Polak, *Be Just Before You’re Generous: Tithing and Charitable Contributions in Bankruptcy*, 29 CREIGHTON L. REV. 527, 575 (1996); Donald R. Price & Mark C. Rahdert, *Distributing the First Fruits: Statutory and Constitutional Implications of Tithing in Bankruptcy*, 26 U.C. DAVIS L. REV. 853, 855, 901-16 (1993); Aric D. Martin, *Chapter 13 and the Tithe: Is God a Creditor?*, 56 OHIO ST. L.J. 307, 322-25 (1995). *See also* Chapter 13 Trustee District of Nebraska Budgetary Guidelines, 6 NAT’L ASS’N CH. 13 TRUSTEES Q. 16 (1994) (listing charitable contributions as specific expense item in budget guidelines). The Religious Liberty and Charitable Donation Protection Act of 1997, S. Bill 1244, introduced on October 1, 1997, expressly would amend section 1325 to include some charitable contributions in reasonably necessary expenses. A companion bill, H.R. 2604, was introduced on October 2, 1997.

⁶⁹³ *See, e.g., In re Sutliff*, 79 B.R. 151, 156 (Bankr. N.D.N.Y. 1987) (“an inquiry into a debtor’s ‘reasonably necessary’ expenses is unavoidably a judgment of values and lifestyles and close questions emerge.”); *In re Rogers*, 65 B.R. 1018, 1021 (Bankr. E.D. Mich. 1986) (“This question unavoidably involves the bankruptcy court in difficult value judgments.... It’s an unpleasant job, but someone has to do it”); KEITH LUNDIN, 1 CHAPTER 13 BANKRUPTCY § 531, 5-981-99 (Wiley Law Publications, 1992) (“Determining reasonable necessary expenses drags the bankruptcy court into approving or disapproving of the debtor’s lifestyle”); Karen Gross, *Preserving A Fresh Start For the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59 (1986).

⁶⁹⁴ This issue was discussed at length at the Commission’s consumer bankruptcy working group brainstorming session in Dallas, Texas on April 5, 1997.

responsible for many debtors' ultimate resort to the bankruptcy system. However, the basis of the disposable income concept is the debtor's budget. Chapter 13 rewards debtors who over-encumber their budgets with "reasonably necessary" expenses by requiring them to pay less to their unsecured creditors. A debtor who purchases a big car and some new furniture on credit and moves to a larger apartment shortly before bankruptcy may be obligated to pay less to the unsecured creditors than a debtor with the same income with an old car and old furniture and a smaller apartment. In either case, the debtor cannot keep the income. The question economically is whether the debtors' income will be channeled to unsecured debt or whether the debtor can use the income in ways that will qualify as "reasonably necessary expenses." The system essentially penalizes debtors willing to downsize their expenses because every penny earned, but not spent, must go to unsecured creditors. This practice also leads to inconsistency in outcome since debtors with less aggressive counsel or no counsel will have larger repayment obligations than debtors with counsel who help them shelter their incomes.

Because a disposable income test encourages the incurrence of expenses that many debtors have shown they cannot afford, one might surmise that the high noncompletion rate in Chapter 13 is partly attributable to the structure of the repayment system. By requiring a debtor to give up all income in excess of "reasonably necessary expenses," the debtor may continue to incur obligations in excess of her repayment capacity. When another financial setback occurs, the debtor has less flexibility to deal with the problem either through modest savings or by reducing payments to unsecured creditors. It thus is possible that the disposable income test contributes to high noncompletion rate in Chapter 13.

To deal with the overwhelming confusion, some trustees or districts have developed guidelines on acceptable necessary expenses to help the court and trustee make the required value judgments on the debtor's lifestyle.⁶⁹⁵ The guidelines may ameliorate some inefficiencies of this process, but they create *de facto* rules that differ widely even from judge to judge or trustee to trustee in the same district. Neither the Bankruptcy Code nor local rules could ever provide a blueprint for determining "reasonably necessary expenses" in a way that accounts for infinite

⁶⁹⁵ See Kathleen A. Laughlin, *A Chapter 13 Trustee's Guidelines for Determining Disposable Income: A Task that Would Give a Woodpecker a Headache!* 6 NAT'L ASS'N CH. 13 TRUSTEES Q. 13 (Jan. 1994) (describing problems and attaching guidelines on reasonably necessary expenses for District of Nebraska); see also Affidavit of Arnold H. Wurhman, Staff Attorney in office of Amrane Cohen, Chapter 13 Trustee in the Central District of California (May 7, 1997) (delineating procedures for his preparation of table of monthly average income and expenditures based on consumer expenditure survey of U.S. Department of Labor Bureau of Labor Statistics and Consumer Price Index-All Urban Consumers for Los Angeles-Long Beach area). See generally Letter from Kathleen A. McDonald, President, National Association of Chapter 13 Trustees regarding Consumer Bankruptcy Working Group Proposals, (June 11, 1997) (commenting that most trustees have written or unwritten templates and attaching some examples).

regional, cultural, and personal differences. What such attempts do, however, is provide an incentive to build budgets around the rules to limit the amount of disposable income without sacrificing the feasibility of the plan.⁶⁹⁶ A debtor with good legal advice will budget with two guiding principles: 1) list expenses in categories that a particular judge or trustee thinks are reasonably necessary;⁶⁹⁷ 2) list high enough expenses to leave no disposable income. The resulting information on schedules and budgets filed with the court has been likened to the “great American novel.”⁶⁹⁸ This practice is inconsistent with the goal of promoting accurate disclosures and enhancing the integrity of the system.

Perhaps because of these shortcomings, the disposable income requirement has taken on an equally troubling counterpart in some jurisdictions. Some courts and trustees have developed informal “guidelines” on the minimum percentage of unsecured debt that must be committed to satisfy the good faith requirement.⁶⁹⁹ Some courts throughout the country will not confirm plans that provide less than a certain percentage of repayment to unsecured creditors. A percentage requirement creates an insurmountable barrier for debtors with no disposable income who seek relief under Chapter 13, perhaps to save a home or a car by curing a default. Had the debtor’s case been assigned to another judge who will confirm plans that promise no payments to unsecured creditors, the outcome would have been different.⁷⁰⁰ Once

⁶⁹⁶ See Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 532 (1993) (explaining practice of some lawyers of computing plan payment necessary to pay debts including required percentage of debt and working backward to derive budget, leading to inaccuracies).

⁶⁹⁷ See Jean Braucher, *Counseling Consumer Debtors To Make their Own Informed Choices—A Question of Professional Responsibility*, 5 AM. BANKR. INST. L. REV. 165, 183 (1997) (stating that listing all possible budget items will help debtor identify expenses and plan accordingly, but court may refuse certain of these items as luxuries and not reasonably necessary, thus noting that it may not be advisable to actually list items on schedules).

⁶⁹⁸ Statement of Hon. Robert Ginsberg, Transcript from February 20, 21, 1997 Meeting. See also Letter from Hon. Edith Jones, regarding consumer bankruptcy (July 15, 1997) (attaching court order from U.S. Bankruptcy Court for the Southern District of Texas describing how “bankruptcy mill practitioner was able to run an efficient shop. He and his paralegals made up the debtors’ expense statements so that they would not reflect much disposable income.”).

⁶⁹⁹ 11 U.S.C. § 1325(a)(3) (1994).

⁷⁰⁰ See, e.g., *In re Greer*, 60 B.R. 547 (Bankr. C.D. Cal. 1986) (zero-repayment plans legally permissible); Hon. C. Michael Stilson, U.S. Bankruptcy Judge, Northern District of Alabama, Comments on the National Bankruptcy Review Commission Consumer Bankruptcy Working Group’s May 6, 1997 Draft, at 3 (June 6, 1997) (predetermined percentage requirements is contrary to language of Bankruptcy Code). An informal survey of the judges in the Seventh Circuit revealed that of 24 judges responding, 13 sometimes confirmed zero percent payment plans and 11 never confirmed zero percent payment plans. Letter from Hon. Russell Eisenberg to Elizabeth Warren,

again, extremely different legal rules are being applied to cases with similar sets of facts.⁷⁰¹

Notwithstanding the generic good faith requirement of section 1325(a)(3), minimum repayment requirements appear to run directly counter to the premise of the disposable income requirement because they focus on the amount owed to creditors, not on the amount the debtor can pay. Higher percentage requirements also do not necessarily correlate with higher actual returns to unsecured creditors because debtors presently can cure a secured debt default and exit the Chapter 13 system before paying anything to unsecured creditors. High minimum payment requirements may contribute to the high noncompletion rate in Chapter 13, where more modest repayment plans might have been plausible for more debtors.

The Commission proposes a principled basis for determining unsecured creditors' entitlements throughout the course of Chapter 13 plans. The Recommendation diverges from both the statutory disposable income test and the court-mandated percentage-of-debt tests. The Commission endorses the concept of a standardized payment based on a graduated percentage of adjusted gross income. A sample guideline that has provided a point of departure for the Commission's discussion referred to nominal repayment by debtors with incomes below \$20,000, and a graduated repayment requirement climbing to about 5% of adjusted gross income annually for debtors with incomes above \$75,000. The percentage guideline could be adjusted based on the number of dependents claimed for income tax purposes. The Chapter 13 trustee would be responsible for verifying the debtor's income and for reviewing the debtor's income annually for changes that might necessitate modification of the required amounts upward or downward. To this end, debtors would be expected to provide any supplementary documentation at the request of the trustee.

The Chapter 13 trustee would monitor all debt repayments, as most do in the current system, and would make the *pro rata* distributions to unsecured creditors, including those holding nondischargeable debts. The trustee or any unsecured creditor could file an objection to a plan that deviated from the guidelines. A court

(December 14, 1992) (attaching Chapter 13 Questionnaire of Bankruptcy Judges in the Seventh Circuit). See William C. Whitford, *Has the Time Come to Repeal Chapter 13?* 65 IND. L. J. 85, 97 n.39 (1989) (practitioners often assume that debtors should not file zero or low percentage repayment plans because they are burdensome on Chapter 13 trustees and because they believe certain bankruptcy courts will not approve the plans).

⁷⁰¹ See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J. L. & PUB. POL. 801, 833 (1994) (results of empirical study show that courts and trustees in various districts have different expectations of percentage of unsecured debt that must be pledged in Chapter 13 repayment plans).

would review such an objection to determine whether the circumstances justified the deviation. For example, a lower percentage payment may be appropriate for a debtor who faced extraordinary expenses because of a chronically ill dependent or if the local cost of living was very high.

Several factors should be considered in determining the exact numbers to use in the guideline. The proposed standardized payment is exclusively for unsecured debts. Debtors often have substantial payments on home mortgages, car loans, furniture loans, or priority debts. In addition, debtors would still be required to meet the “best interest” test to confirm a Chapter 13 plan for both secured and unsecured creditors.⁷⁰² This means, for example, that if the unsecured creditors would have received more in a Chapter 7 liquidation, the debtor will have to pay more than the income guideline amount to meet that requirement. Debtors also would be free to pay more if they voluntarily chose to do so.

The recommended approach to Chapter 13 unsecured debt payments should yield more certainty, while providing some flexibility when needed. It achieves equity and consistency without forcing debtors into a cookie cutter mold of income and expenses that others deem appropriate. While the outcomes will not be the same in every case in a system dealing with so many different family circumstances, a system that begins at a single point nationally and requires justification for deviation should provide fairer and more predictable results to both debtors and creditors. Creditors would benefit from this consistent approach because they could better anticipate recoveries. This Recommendation should make case monitoring easier and less expensive. Judicial resources also could be used more efficiently to decide other legal disputes.

Income-based unsecured debt payments also should complement efforts to improve debtors’ budgeting practices, while they promote debtor autonomy in determining what expenses fit their budgets. As part of the bargain in Chapter 13, debtors would have a reasonable, fixed payment on their general unsecured debt through the life of the plan (unless their adjusted gross incomes change) and could budget accordingly. Because the amounts required by the guideline are a percentage of income and not dollar for dollar, the system would not discourage a debtor from increasing productivity. A debtor might use Chapter 13 as the time to make sensible economic decisions, moving to a more modest apartment or driving a less expensive car. The debtor would have an incentive to cut other costs to establish long-term financial stability. Ultimately, this provision offers hope to increase the success rate in Chapter 13, providing concomitant benefits for both debtors and creditors. Some debtors’ representatives have acknowledged that this approach serves educational and

⁷⁰² 11 U.S.C. § 1325(a)(4), (5) (1994).

rehabilitative functions by giving debtors incentives to be more realistic about the house and car payments they can afford.⁷⁰³

A standardized approach to unsecured debt repayment has not been embraced universally. Some lawyers, judges, and academics prefer the subjective approach to determine the appropriate unsecured debt payment.⁷⁰⁴ They have argued that more plans may fail if the payments do not reflect a debtor's individual circumstances. A debtor who cannot afford the amount prescribed by the guideline may also be unable to afford to litigate eligibility for a variance.

In addition, because the unsecured debt payment generally would become independent of other obligations, higher mortgage payments may render a plan infeasible, and therefore some families will not be able to save their homes from foreclosure. Debtors who have consolidated unsecured debts by taking another mortgage are even more likely to have this problem. Thus, some would prefer that actual housing costs be taken into account.

As an alternative, some might endorse an amendment to clearly establish that courts are not to impose minimum debt percentages, but most likely would go no further to change the current methods of determining unsecured debt payments. Conversely, recently introduced legislation, The Responsible Borrower Protection Bankruptcy Act, H.R. 2500, would substitute the disposable income requirement with a "monthly net income" concept, which would entail a multi-step calculation based on the Internal Revenue Service expenditure levels.⁷⁰⁵

The Commission's recommended guideline approach for unsecured debt payment in Chapter 13 was not designed or intended to be applied to debtors in Chapter 7 to determine whether they should be in Chapter 13. Unsecured debt repayment requirements have played a part in the interpretation of a controversial section of the Bankruptcy Code, section 707(b). Section 707 sets forth grounds for dismissal of a Chapter 7 case, and subsection (b) authorizes the court or the U.S. trustee to bring a motion to dismiss an individual's Chapter 7 case involving

⁷⁰³ See Letter from Robert R. Weed (June 15, 1997).

⁷⁰⁴ See, e.g., Hon. Marilyn Morgan, U.S. Bankr. Judge, Northern District of California, Comments for the National Bankruptcy Review Commission (May 14, 1997) (stating that she could not imagine a standardized disposable income approach that will encompass diversity in Chapter 13 cases); Karen Gross, *Preserving A Fresh Start For the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments*, 135 U. PA. L. REV. 59 (1986).

⁷⁰⁵ See H.R. 2500, Section by Section Analysis Title I, § 102. "Adequate Income Shall Be Committed to a Plan that Pays Unsecured Creditors" (Issued by Rep. McCollum, Sept. 17, 1997).

primarily consumer debts if the case and the ultimate discharge of debt would be a “substantial abuse” of Chapter 7.

Courts have been divided over whether ability to pay some portion of one’s debts is substantial abuse of the Chapter 7 discharge. Some courts, including the Eighth and Ninth Circuit Courts of Appeals, have held that ability to pay a substantial percentage of debt out of future income is grounds for dismissal of a Chapter 7 case.⁷⁰⁶ Under this type of approach, some courts will find a Chapter 7 case to be substantial abuse only if the debtor could have paid 100% of debts in a reasonable period of time.⁷⁰⁷ The Court of Appeals for the Sixth Circuit took a slightly broader approach, but ultimately determined that the debtor’s ability to repay may be sufficient to support a finding of substantial abuse. The debtor’s ability to pay would be a mandatory consideration, but other factors could rebut whatever presumption of substantial abuse was created by the debtor’s apparent repayment ability.⁷⁰⁸ Taking a different course, the Court of Appeals for the Fourth Circuit has held that a Chapter 7 debtor’s ability to repay a substantial percentage of debt, in itself, could not support a finding of substantial abuse.⁷⁰⁹ Rather, substantial abuse must be assessed on a case-by-case basis in view of the “totality of circumstances” to see if the case is abusive overall.⁷¹⁰ Under any of these approaches, courts that review cases for repayment ability closely scrutinize the details of the life and

⁷⁰⁶ See *In re Kelly*, 841 F.2d 908, 915 (9th Cir. 1988) (excess monthly income of \$440 not reasonably necessary for support and excessive recreation expenses warranted dismissal), citing *In re Hudson*, 56 B.R. 415, 419 (Bankr. N.D. Ohio 1985) (debtor’s ability to pay debts when due is substantial abuse of Chapter 7); *In re Huckfeldt*, 39 F.3d 829 (8th Cir. 1994); *Fonder v. United States*, 974 F.2d 996 (8th Cir. 1992) (debtor able to pay 89% of debts in three years); *In re Walton*, 866 F.2d 981 (8th Cir. 1989) (could pay two-thirds of debt in three years), *aff’d*, 866 F.2d 981 (8th Cir. 1989); *Stuart v. Koch*, 109 F.3d 1285 (8th Cir. 1997).

⁷⁰⁷ See, e.g., *In re Zaleta*, 211 B.R. 178 (Bankr. M.D. 1997) (Chapter 7 case not substantial abuse because debtor not able to pay all debts in reasonable time).

⁷⁰⁸ *In re Krohn*, 886 F.2d 123, 126 (6th Cir. 1989). See also *Ontiveros*, 198 B.R. 284, 288 (D. Ill. 1996).

⁷⁰⁹ *In re Green*, 934 F.2d 568, 572 (4th Cir. 1991); see also *Balaja*, 190 B.R. 335, 338 (Bankr. N.D. Ill. 1996) (arguing that per se rule of Eighth and Ninth Circuits would give no effect to clearly stated statutory presumption in favor of granting relief to debtor).

⁷¹⁰ *Green*, 934 F.2d at 572; see also *In re Kestell*, 99 F.3d 146, 149 (4th Cir. 1996) (debtor attempted to substantially abuse bankruptcy system by seeking to avoid paying ex-wife while reaffirming all debts to other creditors and failing to disclose all assets); *In re Shands*, 63 B.R. 121, 124 (Bankr. E.D. Mich. 1985) (same); *In re Deaton*, 65 B.R. 663, 665 (Bankr. S.D. Ohio 1986); *In re Keniston*, 95 B.R. 202 (Bankr. D. N.H. 1988) (ability to pay debts without additional factors amounting to bad faith was not substantial abuse).

expenses of the debtor and related parties,⁷¹¹ similar to the disposable income analysis. The inquiry is heavily fact intensive and consumes substantial judicial resources when it arises.

The Commission's Consumer Bankruptcy Working Group discussed section 707(b), but did not make a recommendation on the appropriate interpretation or changes to that provision. The Commission's endorsement of guidelines to replace the problematic disposable income requirement was not intended to be applied to Chapter 7 debtors to be a proxy for substantial abuse, for this would stretch the term "substantial abuse" beyond recognition.

Note on Attorneys' Fees. The payment of attorneys' fees in Chapter 13 cases presents distinct problems. Attorneys' fees payment methods in Chapter 13 currently differ widely around the country.⁷¹² Some courts treat attorneys' fees as administrative expenses.⁷¹³ Other courts will stretch out attorneys' fees through the

⁷¹¹ See *In re Haffner*, 198 B.R. 646, 649 (Bankr. D. R.I. 1996) (reducing expenses attributable to "900 number" calls made by nondebtor spouse's son from prior marriage, determining that case should be dismissed for substantial abuse); *In re Dickerson*, 193 B.R. 67, 68 (Bankr. M.D. Fla. 1996) (going through details of debtor's medical operation and resulting expenses in great mathematical detail, determining that case was not substantial abuse because there was at least a \$400/month deficit). A judge may be inclined to investigate the income and expenses of a nondebtor spouse as well. Cf. *In re Haffner*, 198 B.R. at 649 (declining to include nondebtor's income, but also refusing to include expenses that court found attributable to nondebtor spouse's child from prior marriage), with *In re Strong*, 84 B.R. 541 (Bankr. N.D. Ill. 1988) (including nondebtor spouse's annual income of \$38,000 in substantial abuse analysis).

⁷¹² KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY, § 7.31 (2d ed. 1994) (noting that the method of payment of chapter 13 attorneys fees has been litigated and varies widely).

⁷¹³ See, e.g., *In re Shorb*, 101 B.R. 185 (B.A.P. 9th Cir. 1989) (chapter 13 debtor's attorney fees must be paid before or contemporaneously with other claims, reversing bankruptcy court order providing that attorney's fees not be paid until 6 months after commencement of payments to unsecured creditors); see, e.g., *In re Tenney*, 63 B.R. 110 (Bankr. W.D. Okla. 1986) (approving chapter 13 plan paying administrative expenses in full before secured claims) *In re Cason*, 190 B.R. 917 (Bankr. N.D. Ala. 1995) (attorney's fees, like administrative expenses, must be paid before or at same time as other claims). This case also notes that the Bankruptcy Court for the Northern District of Alabama has adopted a "Memorandum On Compensation in Chapter 13 Cases." Pursuant to the Memorandum, debtors attorneys will receive an initial distribution and subsequent monthly payments as an administrative expense by the standing trustee. The amount paid to the debtor's attorney depends on the amount of claims paid by the standing trustee.

life of the plan.⁷¹⁴ Still others allow certain plan payments to be applied exclusively to attorneys' fees.⁷¹⁵ Each approach inherently involves different incentives.⁷¹⁶

The Commission could find no specific justification for the diversity in approaches, but it did not determine an appropriate single practice to recommend. The Commission specifically sought further comment on this issue, although received very little feedback; one attorney validated the notion that the treatment of Chapter 13 cases and attorneys' fees varied from district to district and judge to judge, and commented that some courts do not account sufficiently for the added time and effort associated with diligent representation of a Chapter 13 debtor as compared with a Chapter 7 debtor.⁷¹⁷

1.5.5 Consequences of Incomplete Payment Plans

The Bankruptcy Code should provide that a case under Chapter 13 that otherwise meets the standards for dismissal shall be converted to Chapter 7 after notice and a hearing unless a party in interest objects on the basis that the debtor had been granted a discharge in a Chapter 7 case commenced within six years of the date on which the conversion would take place, in which case the Chapter 13 case will be dismissed. In addition, the debtor may object to conversion without grounds, in which case the Chapter 13 case will be dismissed. The standards for modification, dismissal, and discharge in Chapter 13 would not otherwise change.

Section 542 should be amended to provide that the filing of a petition by an individual does not operate as a stay if the individual has filed two or more petitions for relief under title 11 within six years of filing the

⁷¹⁴ See, e.g., *In re Lanigan*, 101 B.R. 530 (Bankr. N.D. Ill. 1986) (court authorized to spread payment over life of plan, and approving attorney fees spread out over number of months).

⁷¹⁵ See, e.g., *In re Parker*, 15 B.R. 980 (Bankr. E.D. Tenn. 1981), *aff'd*, 21 B.R. 692 (E.D. Tenn. 1982) (administrative expenses may be paid concurrently with payments to other claim holders); See Bankruptcy Court for the Northern District of California, Oakland Division, Standing Order: "Rights and Responsibilities of Chapter 13 Debtors and their Attorneys," (June 1, 1994) (providing that attorneys get paid through plan unless otherwise ordered; "attorney may not receive fees directly from the debtor other than the initial retainer").

⁷¹⁶ *In re Lanigan*, 101 B.R. 530 (Bankr. N.D. Ill. 1986) (spreading out payments will make attorney pay more attention to the proposed plan so that attorney shares risk of potential plan failure).

⁷¹⁷ Letter from Melvin James Kaplan, Chicago, IL to Melissa Jacoby (June 26, 1997); See also memorandum from Jean Braucher, regarding Comments on June 10, 1997 Draft Proposals Concerning Consumer Bankruptcy 2 (July 8, 1997).

instant petition for relief and if the individual has been a debtor in a bankruptcy case within 180 days prior to the instant petition for relief. On the request of the debtor, after notice and a hearing, the court may impose a stay for cause shown, subject to such conditions and modifications as the court may impose.

About two-thirds of Chapter 13 cases are converted or dismissed before a debtor completes repayment of a plan of reorganization. The Commission's Recommendations are designed to encourage and enable plan completion by requiring a full term to cure and reinstate secured debt and by standardizing the unsecured debt payment. Even so, nothing can guarantee that consumer debtors will always be able to complete their Chapter 13 plans successfully. Another financial bump in the road can easily derail a consumer plan, especially when a debtor has little financial reserve. A lost job or an unexpected expenses can quickly change the feasibility of a plan.

When a debtor ceases making plan payments, several consequences can follow under current law. The plan can be modified or suspended for a period of time if requested.⁷¹⁸ Alternatively, the debtor may convert the case to a Chapter 7 liquidation.⁷¹⁹ If a debtor can establish certain facts, the debtor might be entitled to a "hardship discharge" of debts that would have been discharged in a Chapter 7 case.⁷²⁰ The debtor, the trustee, or a creditor may ask that the case be dismissed, with no discharge of debt.⁷²¹

If the debtor is advised by a careful lawyer, the option chosen will reflect the debtor's particular situation. A short-term setback in income might justify a minor modification or several month suspension. On the other hand, a significant financial setback or complete infeasibility may lead the diligent debtor's attorney to seek conversion to Chapter 7 or a "hardship discharge" in Chapter 13.

⁷¹⁸ 11 U.S.C. § 1329 (1994) (party can request modification to increase or reduce payments, extend or reduce time for payments, or alter amount of distribution to creditor).

⁷¹⁹ 11 U.S.C. § 1307(a) (1994) (debtor may convert to Chapter 7 at any time, and any waiver of right to convert is unenforceable).

⁷²⁰ 11 U.S.C. § 1328(b) (1994) (after notice and hearing, court may grant discharge in spite of noncompletion if debtor's failure to complete payments is due to circumstances for which debtor should not be held accountable, if value actually distributed is not less than amount creditors would have received in Chapter 7, and modification under section 1329 is not practicable).

⁷²¹ 11 U.S.C. § 1307(b) (1994) (debtor has right to seek dismissal at any time), § 1307(c) (grounds for converting or dismissing, including unreasonable delay or material default under plan).

However, not all debtors are represented after their plans are confirmed and payments have commenced. Some debtors never had legal help, and others have no continuing relationship with the lawyers who helped them file the initial papers and appeared with them at the meeting of creditors. For debtors without careful advice, the default position under current law is dismissal of the case with no discharge of any debt. Thus, after paying a filing fee, attorneys' fees, and several months or years of payments under the plan, the debtor may be back where she started. In fact, the debtor may be more financially burdened than at the time of the filing due to liability for unpaid unsecured debts including compounded interest that has accrued since the case commenced. If a debtor later realizes that she experienced only a short term setback and wants to try again to repay, or if she needs a discharge to prevent the collection efforts that initially drove her to the bankruptcy system, she will have to pay another filing fee and potentially another attorneys' fee to re-enter Chapter 13.

This situation highlights several shortcomings of the current system. The complexity of the system prevents the people most in need of relief from receiving it. More sophisticated debtors with good legal advice can make the proper choices. Other debtors are ousted from the system after paying a filing fee and adding to the administrative burden of the bankruptcy system. They will face substantial costs if they attempt to re-enter: debtors' limited resources are allocated to multiple filing fees and attorneys' fees rather than to creditors or to the debtor's financial rehabilitation.

To help address these problems, the Commission does not introduce a new rule, but rather, recommends changing the default rule when a Chapter 13 plan languishes. Rather than penalizing debtors who attempted to repay their debts in Chapter 13,⁷²² the system should give them the discharge they would have received had they originally filed under Chapter 7. The Commission recommends that absent an affirmative step by the debtor to modify, suspend, or dismiss, failure of a Chapter 13 plan presumptively should lead to conversion to Chapter 7. Conversion would occur only after an opportunity for notice and hearing, and a debtor's case could not be converted if the debtor was barred from receiving a Chapter 7 on account of a prior Chapter 7 case. If a national filing system is implemented, as the Commission recommends, this fact easily would be discovered. A debtor would retain the option to have a Chapter 13 case dismissed without converting to Chapter 7. This route might be sensible for someone who secured lucrative employment and preferred to work with her creditors under state law.

⁷²² See Electronic Mail from Derek M. Shirk regarding comment that "many debtors select 7 over 13 because of the risk that they will not receive a discharge in 13" (May 26, 1997).

The Commission does not propose a new option. The Code already provides an unequivocal and nonwaivable right to convert from Chapter 13 to Chapter 7.⁷²³ Yet, under the current system, a debtor needs to know enough about the bankruptcy system to request such relief, and many do not. According to an analysis of termination data for Chapter 13 cases filed between 1980 and 1988 conducted by the Administrative Office of the U.S. Courts, dismissal was the most common disposition of Chapter 13 cases: 49% were dismissed, whereas only 14% were converted to Chapter 7.⁷²⁴ Only 36% received a discharge at all.⁷²⁵

This Recommendation is similar in intent, but slightly different in detail to a proposal adopted by the Consumer Bankruptcy Reform Forum of the American Bankruptcy Institute, which involved approximately 50 practitioners, judges, academics, trustees, and others representing the views of both debtors and creditors.⁷²⁶ This group recommended that a debtor in an uncompleted Chapter 13 receive a Chapter 7-type discharge in Chapter 13 due to concerns about paying the Chapter 7 trustee to administer the estate in a no-asset case when there is no new filing fee. In effect, the ABI proposes that the Chapter 13 trustee serve the supervisory functions of the Chapter 7 trustee.

Repeat Access

The combination of easy access to Chapter 13 and a high noncompletion rate leads to the possibility of a significant number of repeat bankruptcy filings. While the data are sparse because of the lack of a centralized filing system, various efforts have been made to determine the extent to which debtors enter the bankruptcy system multiple times.⁷²⁷ According to both formal and informal surveys, Chapter 13 trustees

⁷²³ 11 U.S.C. § 1307(a) (1994).

⁷²⁴ Michael Bork and Susan D. Tuck, Administrative Office of the U.S. Courts Bankruptcy Statistical Trends; Chapter 13; Dispositions (Working Paper 2) (October 1994) (studying termination data for Chapter 13 cases filed between 1980 and 1988).

⁷²⁵ *Id.*; see also TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA (Oxford Univ. Press 1989) (of 481 Chapter 13 cases in sample, 107 already had been dismissed at time of writing, whereas only 48 had been converted to Chapter 7).

⁷²⁶ See ABI Consumer Bankruptcy Reform Forum Summary and Report on Options (Not dated), which can be found in the Appendix.

⁷²⁷ See Visa, U.S.A., Inc. Preliminary Report, Consumer Bankruptcy, Bankruptcy Debtor Survey (April 1997) (of "more than 3,500" former Chapter 7 and 13 debtors responding, 8.6% stated that they had filed 2 cases and 2.5% reported to have filed three or more cases); TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY

in various regions appear to see widely divergent numbers of repeat filers, with the responders identifying anywhere from 1% to 40% their cases being filed by individuals who have been debtors previously.⁷²⁸

It is equally and perhaps more significant to determine *why* debtors file more than once, an analysis that has been undertaken by some judges and scholars.⁷²⁹ People take different views on whether repeated access to consumer bankruptcy relief is abusive, but the answer to that question is often fact-specific. Parties file for bankruptcy relief repeatedly for different reasons. Among the possibilities:

Changing employment circumstances, family crises, or persistent financial difficulties cause some debtors to fall in arrears in their Chapter 13 plans. They may not be aware of the option to suspend or modify, or the problem may not appear to have an end in sight. These debtors may see their plans dismissed, and they may file again later to make another attempt to repay when their circumstances improve. Similarly, debtors might have been overly optimistic about their future earnings and ability to fund substantial plan payments.

Some debtors file more than once because their first trip through bankruptcy failed to give them adequate debt relief. A debtor might file for Chapter 7, for example, but emerge with an inadequate discharge because the debtor reaffirmed too much debt, leading to future financial distress. Other debtors might emerge from Chapter 7 still burdened with debt because they received erroneous or inadequate advice about whether their debts were dischargeable in Chapter 7 (or at all) or too quickly settled with creditors threatening to file nondischargeability actions. Still in need of debt relief, a person in this situation might file a Chapter 13.

AND CONSUMER CREDIT IN AMERICA (1989) (about 8% of debtors in sample of 1502 petitions had been debtors previously).

⁷²⁸ Susan L. DeJarnatt, Empirical Study—Chapter 13 Repeat Filings; Preliminary Analysis, Draft (September 11, 1997); *see also* statements of Henry Hildebrand, Chapter 13 Trustee, at Meeting of National Bankruptcy Review Commission Consumer Bankruptcy Working Group, Apr. 17-18, 1997 (informal survey of Chapter 13 trustees in 5 cities indicated that of their Chapter 13 cases filed in 1996, percentage of debtors that had filed previous case between January 1, 1990 and December 31, 1996 ranged from 1% to almost 23%).

⁷²⁹ *See, e.g.*, Letter from Hon. Polly S. Higdon, Bankruptcy Judge D. Or., regarding consumer bankruptcy (Sept. 25, 1996) (attaching listing of multiple filings in District of Oregon and analyses by bankruptcy judges of their repeat filers); Susan L. DeJarnatt, Empirical Study—Chapter 13 Repeat Filings; Preliminary Analysis, Draft (September 11, 1997).

A portion of the Chapter 13 debtors do not have positive net income and need a Chapter 7 discharge, but due to external encouragement or moral compulsion, they make ill-fated attempts to pay debts in Chapter 13. When no one recognizes the problem before the case is dismissed (in which case a conversion would have been in order), these debtors pay another filing fee and file a Chapter 7 to get the discharge they needed to deal with their initial financial collapse. Alternatively, not realizing that they still lack the wherewithal to fund a Chapter 13 plan, such debtors might make a second (or third) attempt at repayment in Chapter 13.

Cases may be dismissed and refiled when courts use dismissal as a disciplinary tool. A debtor may miss any number of time deadlines or unintentionally fail to comply with administrative requirements, such as appearing at the section 341 meeting of creditors, filing tax returns, and providing requested information to the trustee.⁷³⁰

While each of these examples of debtors who are in the system for a second or third time point out weaknesses in the system, such as inadequate supervision of reaffirmations or inadequate counseling for debtors in financial trouble, other debtors in the system are not looking for a discharge or a repayment mechanism. These circumstances highlight other weaknesses in the consumer bankruptcy system.

Some debtors file for Chapter 13 only to obtain access to the special tools offered in Chapter 13, such as the stripdown and deacceleration of secured debt and treatment of taxes, to deal with certain creditors but are not committed to making the scheduled payments that accompany these benefits for the full term of the plan.⁷³¹ By filing, they get the benefit of the automatic stay, negotiate with that one creditor, and then allow their cases to be dismissed. If the negotiated deal does not work, they file again to obtain another automatic stay to repeat the negotiation process. The lack of discharge accompanying

⁷³⁰ See letter from Hon. Polly S. Higdon, Bankruptcy Judge D. Or., (April 23, 1997) (citing this as primary reason for repeat filings in numbers of cases); Letter from Hon. Geraldine Mund, Chief Bankruptcy Judge C.D. Cal. (June 23, 1997) (commenting that any time bar should not be triggered by dismissal of case due to debtor error, such as failure to appear at section 341 examination or failure to file schedules or statement of affairs so as not to prejudice pro se filers who do not “get it right” the first time).

⁷³¹ See, e.g., Letter from Mallory Duncan, Vice President & General Counsel, National Retail Federation to National Bankruptcy Review Commission regarding Chapter 13 plan success rates, (June 16, 1997) (some Chapter 13 plans fail because debtors withdraw after partial completion, since courts in most jurisdictions allow debtors to pay secured debt arrearage early in plan).

dismissal enables these debtors to file again, potentially for the same reasons.

Others file on the eve of a foreclosure or eviction for the sole purpose of delaying the state legal process.⁷³² When the threat passes, they dismiss their cases, only to file again when the mortgagee or landlord brings another legal action to seize control of the property. The ability to file repeatedly for Chapter 13 relief increases a debtor's leverage in negotiations with creditors. In regions where this problem is particularly acute, judges have devoted significant time and resources to developing tools to address this problem.⁷³³

Other debtors file Chapter 7 cases to be relieved of dischargeable debts and personal liability, followed by Chapter 13 to restructure secured and nondischargeable debts.⁷³⁴ This "Chapter 20" changes the bargain contemplated in Chapter 13. Alternatively, a debtor might use this approach to bring all debts within the Chapter 13 limits.⁷³⁵

⁷³² See Report of the United States Bankruptcy Court, Central District of California Ad Hoc Committee on Unlawful Detainer and Bankruptcy Mills (Jan. 1997) (reporting that when court formed ad hoc committee, over 16% of consumer cases had been filed primarily to stop eviction, which was down to 1% in 1996); Memorandum from Eric Friedman, Assistant Vice President and Bankruptcy Manager, Countrywide Home Loans regarding barring multifilers (Apr. 14, 1997) (one primary reason for repeat filings is to delay foreclosure); Kirk Loggins, *Author Loses Court Battle; Foreclosure Imminent*, *The Tennessean* (Jan. 4, 1996) (author and husband engaging in "serial and tag team" bankruptcy filings to delay foreclosure for four years).

⁷³³ The Central District of California, commonly cited as the primary locus of the serial filing problem, created an Ad Hoc Committee on Unlawful Detainer and Bankruptcy Mills, comprised of several judges, the U. S. Trustee, attorneys from the U.S. Attorney's Office and other private organizations representing various landlord interests. Since 1991, this committee has monitored the situation. Using a "complex web of law and actions to control the abuse," the committee's data indicates that filings initiated primarily to stop eviction in this district have decreased from 16.9% in 1991 to 1% in 1996.

⁷³⁴ The Supreme Court has confirmed that this two-case approach is viable. *Johnson v. Home State Bank*, 501 U.S. 78, 87 (1991) ("Congress did not intend categorically to foreclose the benefits of chapter 13 reorganization to a debtor who has previously filed for chapter 7 relief"). Reportedly, the technique is becoming "increasingly common." *In re Turner*, Civ. No. 96-16189, 1997 WL 72056 at *5 (B.A.P. 2d Cir. February 27, 1997). Although some courts review the cases comprising a Chapter 20 collectively and with a high level of scrutiny to determine whether the debtor is comporting with statutory requirements and is acting in good faith, see, e.g., *In re Limbaugh*, 194 B.R. 488, 491 (Bankr. D. Or. 1996) (comparing Chapter 20 cases with separate classification in Chapter 13), there is little question that Chapter 20 cases are permitted under the Code as it stands.

⁷³⁵ See 11 U.S.C. § 109 (1994).

Whatever the cause of the dismissal and refiling, debtors may decide not to request a discharge if they are not being pursued by creditors and thus can retain the possibility of refiling. When they refile rather than modify, they can include debt incurred after the first filing in the next repayment plan, albeit with the cost of a new filing fee and perhaps new attorneys' fees. In addition, a debtor who was in substantial arrears in her first Chapter 13 plan, yet had the opportunity to modify, might choose to dismiss and refile. This might yield smaller monthly payments than curing the first plan.

The Commission originally recommended a two-year bar on refilings, regardless of the disposition of the prior case.⁷³⁶ This recommendation was endorsed by home mortgage lenders, who seem to have had particularly trying experiences with repeat filings that delay foreclosure sales.⁷³⁷ This approach was similar to that proposed by Senators Reid and Brown several years ago that would have limited a debtor's eligibility to file a Chapter 13 petition to once every three years.⁷³⁸ While stressing the importance of providing a fresh start to individual debtors, Senator Reid cited the high failure rate of Chapter 13 and questioned the advantages and propriety of permitting continuous access to the bankruptcy system; this amendment would "say to all debtors: You are now in the court of last resort, and because we are granting you the absolute, unquestioned protection of the automatic stay, you will be given one

⁷³⁶ See Summary of Consumer Bankruptcy Framework Proposals (Draft, June 10, 1997) adopted June 20, 1997, reconsidered August 12, 1997. Although the proposal stated that the two-year bar would run from the closure of a Chapter 13 case, this trigger was problematic. See Letter from Hon. Geraldine Mund, Chief Judge, U.S. Bankruptcy Court, Central District of California (June 23, 1997) (noting that closing is artificial time that is dependent on workload of clerk's office as well as documents received from Chapter 7 trustee).

⁷³⁷ See Letter from Dean S. Cooper, Federal Home Loan Mortgage Corp. (Freddie Mac) to National Bankruptcy Review Commission (Mar. 25, 1997) (endorsing two-year filing bar); Memorandum from Eric Friedman, Assistant Vice President and Bankruptcy Manager, Countrywide Home Loans regarding barring multifilers (Apr. 14, 1997) (providing statistics showing that multifilers rarely complete their plans the second or third filing, and thus end result is still filing); Letter from Jennifer Johnson, Bankruptcy Supervisor, FT Mortgage Companies, to Susan Jensen-Conklin, regarding proposed changes to Chapter 7 and Chapter 13 (Apr. 17, 1997) (strongly supporting multi-year ban on refilings); Letter from Michelle D. Viner, Bankruptcy Supervisor, Assistant Secretary, Norwest Mortgage, Inc., Mes Moines, IA to National Bankruptcy Review Commission, regarding discussion paper draft Mar. 3, 1997 (Apr. 25, 1997) (recounting serial filing problems). See also letter from Francis M. Allegra, Deputy Associate Attorney General, U.S. Department of Justice, to National Bankruptcy Review Commission 2 (June 18, 1997) (noting that serial filings are problematic in many jurisdictions and that refiling bar "appears to balance fairly the interests of debtors and creditors, and would curtail abuses of the bankruptcy process by repeat filings").

⁷³⁸ Stating his opposition to the amendment, Senator Howell Heflin stated that the National Bankruptcy Review Commission would be the proper forum to consider the issue of repetitive filings. 140 CONG. REC. S4521-01 (daily ed. Apr. 20, 1994).

opportunity to reorganize your finances for at least every three years.”⁷³⁹ However, other senators did not support restricting a debtor’s subsequent efforts to pay creditors through the Chapter 13 repayment mechanism, and felt that the evidence was not sufficiently overwhelming to justify this substantial change,⁷⁴⁰ and the amendment was not adopted.⁷⁴¹ Similarly, the Commission revisited its recommendation on a two year ban and opted for a different approach.

A significant restriction on access to bankruptcy or to the automatic stay indeed would be an historic change. The evidence still is not sufficiently conclusive on the prevalence of each of the aforementioned causes of refiling to warrant a drastic change in access when a more moderate approach would suffice.⁷⁴² At the same time, frequent and repetitive access to the tools of bankruptcy should be discouraged if one trip to the bankruptcy system provides the relief that Congress intended. Thus, rather than advocating a flat two-year ban, the Commission recommends a more moderate change to deter successive filings. A debtor would not be precluded from filing two petitions within a six-year time frame. If a debtor sought bankruptcy relief for the third time in six years, and within six months of the dismissal or conversion of the second filing, the filing would not trigger an automatic stay.⁷⁴³ The bankruptcy court clerk’s office would not send notice of the bankruptcy to the debtor’s creditors, and thus no creditor actions would be halted, unless the court subsequently ordered that a stay be imposed. The debtor would have the burden of persuading the court to

⁷³⁹ Senator Heflin supports limiting Chapter 13 Eligibility, 3 CONSUMER BANKR. NEWS 5 (June 3, 1994).

⁷⁴⁰ 140 CONG. REC. S4521-01 (daily ed. Apr. 20, 1994). Senator Heflin expressed that the inflexible provision would work hardship on honest debtors who may have legitimate reasons for their prior noncompletion and refiling. *Id.* Senator Grassley characterized the amendment as “using a cannon to go after a fly” and was concerned that the amendment would discourage the use of Chapter 13 repayment plans. *Id.* at S4532.

⁷⁴¹ This amendment was rejected by a vote of 60 to 34. 140 CONG. REC. D407-01 (daily ed. Apr. 20, 1994).

⁷⁴² See Letter from Hon. Polly S. Higdon, Bankruptcy Judge D. Or. (Apr. 23, 1997) (concluding that a uniform and restrictive remedy is not well-suited to variety of causes of repeat filings and advocating an alternative approach to provide more equity to honest debtors while protecting interests of creditors); Letter from Hon. Joe Lee, Bankruptcy Judge E.D. Kentucky, to Commissioner M. Caldwell Butler (July 18, 1997) (recommending more moderate but effective restrictions on successive filings).

⁷⁴³ Some courts issue orders that essentially accomplish this result. *In re McKissie*, 103 B.R. 189 (Bankr. N.D. Ill. 1989) (enjoined from filing another Chapter 13 for one year); *In re Doss*, 133 B.R. 108 (Bankr. ND. Ohio 1991) (enjoined from filing for one year). However, the Commission has recommended that prospective orders that affect rights and obligations in bankruptcy cases not yet filed not be recognized. It is appropriate for this remedy to be provided statutorily.

enter that stay order. This approach should discourage a debtor from filing a nonmeritorious third or subsequent petition on the eve of a foreclosure sale merely to stay the sale,⁷⁴⁴ and thus deals with one of the most frequently cited uses of repeat Chapter 13 filings.

The Recommendation contemplates that other parts of the Chapter 7 and Chapter 13 system would not be changed. The grounds for dismissing or converting a Chapter 13 case, for example, would remain intact, as would the effects of dismissal and conversion. Similarly, the Recommendation does not change either the current “best interest” standard or the Chapter 7 requirements for debtors whose cases were converted from Chapter 13.

1.5.6 *In Rem Orders*

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay with respect to property of the estate transferred to that individual by another individual who was a debtor under title 11 within 180 days of the filing of the instant petition, unless the court grants a stay with respect to such property after notice and a hearing on request of the debtor.

After notice and a hearing, a bankruptcy court should be empowered to issue *in rem* orders barring the application of a future automatic stay to identified property of the estate for a period of up to six years when a party could show that the debtor had transferred such real property or leasehold interests or fractional shares of property or leasehold interests to avoid creditor foreclosure or eviction. A subsequent owner of the property or tenant of the leasehold who files for bankruptcy (or the same owner or holder in a subsequent filing) should be permitted to petition the bankruptcy court for the imposition of a stay to protect property of the estate, which the court would be required to grant to protect innocent parties who were not a part of a scheme to transfer the property to hinder foreclosure or eviction.

Judges, practitioners, and creditor representatives in some regions of the country have reported on a scheme that uses the bankruptcy process to prevent foreclosure sales repeatedly. The property owner makes a gift of, or assigns for little or nominal consideration, fractional interests in the property to related individuals or

⁷⁴⁴ Letter from Hon. Joe Lee, Bankruptcy Judge E.D. Kentucky, to Commissioner M. Caldwell Butler (July 18, 1997) (delineating effects of this recommendation); *see also* Letter from Hon. Robert W. Alberts, United States Bankruptcy Judge C.D. Cal., to the National Bankruptcy Review Commission (May 7, 1997) (endorsing withholding of automatic stay on subsequent filings).

entities on the eve of foreclosure.⁷⁴⁵ One of the transferees then files a Chapter 13 petition immediately after receipt of its fractional interest, thereby staying the foreclosure sale. In the typical case, the transferee does not fulfill the duties imposed on the debtor by the Bankruptcy Code. The transferee may fail to attend the first meeting of creditors or to file its schedules. Consequently, often before the creditor can obtain relief from the automatic stay, the transferee's bankruptcy case is dismissed on motion of the trustee. Following the dismissal, the creditor cannot simply resume the foreclosure process. The transferee can attempt to file a new bankruptcy case if such action has not been barred, a situation that is addressed in the prior Recommendation. In the alternative, after the transferee's first bankruptcy case has been dismissed, the property owner can transfer another fractional interest in the property to a new individual or entity, who then files a bankruptcy petition, causing the automatic stay to be imposed against the same property. Like the previous transferee, this transferee will make no progress in the bankruptcy case, and the case will be dismissed. The scheme can continue indefinitely, delaying the foreclosure sale, and increasing the costs for the creditor.⁷⁴⁶ In some instances, the creditor succeeds in obtaining relief from the stay, and forecloses on the property. However, if the owner has assigned fractional interests in the property, it is likely that the assignee did not receive notice of the foreclosure sale. Thus, the sale is vulnerable to attack, while the creditor's costs continue to mount.

Landlords also have reported to the Commission that they are having difficulty with the wrongful use of Chapter 13 to obtain the automatic stay.⁷⁴⁷ As with an ownership interest, parties can transfer shares of the leasehold interest, or place multiple names on the lease, and then each individual or entity sequentially files a Chapter 13 petition, to prevent eviction. By doing so, the parties avoid paying rent while also repeatedly preventing eviction. This practice is most harmful to small

⁷⁴⁵ See Memorandum from Michael S. Polk, Polk Scheer & Prober, regarding repeat filings (Apr. 15, 1997) (describing sophisticated strategies to avoid foreclosure, and recommending statutory authority for courts to provide *in rem* relief); see also Michael S. Polk, *Stop the Attack of the Equity Skimmers*, MORTGAGE BANKING 82 (Feb. 1988) (advising lenders how to protect equity position by guarding against techniques that use bankruptcy to postpone foreclosure).

⁷⁴⁶ Another variation apparently is for transferors to fill out several deeds in blank, each transferring a partial interest, and then to hire homeless people to be the transferee and to file for bankruptcy. See Letter from Geraldine Mund, Chief Bankruptcy Judge C.D. Cal. to National Bankruptcy Review Commission regarding *In rem* orders (June 23, 1997) (recommending additional amendment to *in rem* proposal).

⁷⁴⁷ See, e.g., Letter from Haydon Stanley, Georgia Apartment Association (June 3, 1997) (reporting that some residents are utilizing loopholes in Bankruptcy Code to circumvent eviction process); Letter from L.A. Buddy Patrick, Atlanta Apartment Association (June 3, 1997), forwarded by Hon. Newt Gingrich, Speaker, U.S. House of Representatives (August 13, 1997).

landlords with limited holdings who cannot absorb the cost of perennially non-paying tenants.

The transfer of fractional shares by owners or tenants to frustrate lenders' or landlords' exercise of remedies provided under state law is inappropriate. Chapter 13 should not be used in furtherance of this scheme.⁷⁴⁸ Although the practice is rare, and, according to the testimony presented to the Commission, geographically limited, it is an indefensible abuse of the bankruptcy system and should be prohibited before it spreads.⁷⁴⁹ The Commission recommends empowering bankruptcy judges to issue *in rem* orders to eradicate this practice.

An *in rem* order permits the court to grant prospective relief from the automatic stay in connection with identified property. The order will bind any party claiming an interest in that property and will also prevent the property from becoming part of a bankruptcy estate in a subsequent case. These *in rem* orders could be filed in the state property recording system to provide notice to purchasers and other parties.

Some courts already issue *in rem* orders under the apparent authority of state property law.⁷⁵⁰ Other courts addressing the issue have been troubled by issues of due process, namely, limiting the rights of subsequent transferees, or co-owners, without notice having been provided to them.⁷⁵¹ The Commission takes no position with

⁷⁴⁸ “Unwary creditors may suffer losses at the hands of debtors who abuse the multiple filing opportunities provided by Chapter 13.” *In re Nash*, 765 F.2d 1410, 1414 (9th Cir. 1985).

⁷⁴⁹ At the April 1997 meeting in Seattle, Washington, Jill Sturtevant of Bank of America stated that the problem, while most prevalent in the Los Angeles area, is not limited to California. Indeed, in *In re Cherokee New York Inves.*, 1995 WL 548182 (Bankr. E.D.N.Y. 1995) (unreported decision), Judge Marvin Holland addresses the problem.

⁷⁵⁰ See, *In re Snow*, 201 B.R. 968 (Bankr. C.D. Cal. 1996) (impressing equitable servitude on property); *In re Fernandez*, 1997 WL 523997 (Bankr. C.D. Cal. 1997) (unreported decision) (“based on the history of multiple filings and the bad faith of our Debtor and those associated with him, the court concludes that our Debtor is not entitled in this fifth related bankruptcy case to enjoy again the benefits of the automatic stay and that here, the bank was not required to obtain yet another order for relief from the stay before foreclosing on the Sea View property . The Court concludes that the *in rem* relief from stay order entered in the prior Amador bankruptcy case is enforceable against the Debtor, even though the Debtor in this case was not afforded written notice of the bank’s motion for relief from stay in the Amador case”); *In re Amador*, No. 97-14711ES (Bankr. C.D. Cal. Apr. 14, 1997) (unpublished order) (ordering that any relief from stay granted movant will be of full force and effect in this case and in case filed by any other entity claiming interest in subject property within 180 days of entry of order).

⁷⁵¹ See Letter from Hon. Geraldine Mund, Chief Bankruptcy Judge C.D. Cal. to the National Bankruptcy Review Commission regarding consumer bankruptcy issues” (Nov. 25, 1996) (“There

respect to current practices regarding *in rem* orders. However, the Commission has recommended elsewhere in this report that prospective court orders limiting a debtor's rights and obligations in bankruptcy are unenforceable except as authorized by Title 11.⁷⁵² If Congress adopts that Recommendation, a specific amendment authorizing these prospective orders also will be required.

In explaining the problems with tenants filing bankruptcy to delay foreclosure, landlords have requested a different type of statutory relief. They have sought an exception to the automatic stay for month-to-month leases.⁷⁵³ This type of change would entitle a landlord to evict an individual or family in bankruptcy while all other creditor actions were stayed. The landlords argue that they need speedy, cheap access to state eviction proceedings, and that the automatic stay delays them and drives up costs. With an exception to the stay, they reason that they would have no need to go to court and file a motion to terminate the automatic stay in order to continue with eviction proceedings.

There is substantial evidence that an exception to the automatic stay would not accomplish the result for which the landlords strive. A similar exception to the automatic stay to benefit nonresidential landlords has not kept them out of court. Section 362(b)(10) excepts nonresidential leases that were "terminated" prior to the bankruptcy filing.⁷⁵⁴ Although section 362(b)(10) was intended to provide landlords with expedient resolution in state court to reclaim property,⁷⁵⁵ the published case law suggests that the provision has not insulated landlords from time-consuming

has never been a clear decision about whether the court has the power to give orders that are prospective in granting relief from stay and/or that are *in rem* . . . no one really knows if these are valid and enforceable orders"); Memorandum from Michael S. Polk, Polk Scheer & Prober, to the National Bankruptcy Review Commission, regarding repeat filings (Apr. 15, 1997) (judges do not believe they have authority without specific statutory foundation). *See, e.g., In re Cherokee N.Y. Invs.*, 1995 WL 548182 (Bankr. E.D.N.Y. 1995) (unreported decision).

⁷⁵² *See* Chapter 2 of the Report.

⁷⁵³ *See* Memorandum from Clarine Nardi Riddle, Nat'l Multi Housing Council, Nat'l Apart. Ass'n (Oct. 8 & 9, 1996) (attaching preferred language for recommendation excepting from automatic stay any action for eviction, summary process, or unlawful detainer proceedings involving residential real property, and providing that possession of residence by tenant under rental agreement shall not be property of estate).

⁷⁵⁴ Section 362(b)(10) excepts from the automatic stay a lessor's acts to obtain possession of nonresidential real property when a lease has terminated by the expiration of the stated term of the lease, and has been interpreted to apply whether the lease ended by time expiration or on account of a default. *In re Neville*, 188 B.R. 14 (Bankr. E.D.N.Y. 1990).

⁷⁵⁵ *See* S. REP. NO. 98-65, at 68 (1983), *Erickson v. Polk*, 921 F.2d 200, 201 (8th Cir. 1990).

proceedings in the bankruptcy courts.⁷⁵⁶ It is even more likely that the same issue would arise in consumer cases due, in part, to the sheer volume and also to the enhanced protections and elaborate procedures of state law to protect residential tenants. The potential disputes can be predicted by evaluating the litigation that occurs under section 365(a) when courts must determine whether a lease is *unexpired* under applicable state law.⁷⁵⁷ An amendment to section 362 is unlikely to accomplish

⁷⁵⁶ Tenants have initiated litigation in the bankruptcy court to attempt to revive their interests even when there has been conclusive state court litigation, which most bankruptcy courts would agree should have preclusive effect on the status of the lease. See *In re Issa Corp.*, 142 B.R. 75 (Bankr. S.D.N.Y. 1992) (citations omitted). A debtor might bring a contempt action relating to the debtor's eviction even if a state court already found that the debtor received adequate notice, see *In re Neville*, 118 B.R. at 17, or a contempt action in the context of a dispute over whether the lease actually expired; see *In re Hejco, Inc.*, 87 B.R. 80 (Bankr. D. Neb. 1988). In addition, some landlords have had to litigate whether the debtor retained an equitable interest in the property or whether the bankruptcy court should exercise equitable powers to "revive" the lease; see *In re Erie Builders Concrete Co.*, 98 B.R. 737 (Bankr. W.D. Pa. 1989) (finding absence of exigent circumstances that might warrant court's use of section 105 powers to extend debtor's right to possession, after district court already terminated lease extension); *Neville*, 118 B.R. at 18. The process of obtaining the property sometimes is protracted further by motions for reconsideration or to file additional memoranda, see *id.*, or by motions seeking stay's pending appeal. See *In re Urbanco, Inc.*, 122 B.R. 513 (Bankr. W.D. Mich. 1991) (denying stay pending appeal); *Issa*, 142 B.R. at 78 (granting debtor's unopposed request for stay pending appeal of court's denial of motion to assume expired lease, although noting that debtor's argument was of "dubious validity"); *In re Cybernetic Services, Inc.*, 94 B.R. 951 (Bankr. W.D. Mich. 1989) (denying stay pending appeal). Although lessors tend to prevail in these actions involving expired leases, they obtain relief only after the delay attendant to litigation and the decision-making process. It therefore is not surprising that some landlords seek bankruptcy court permission in advance, notwithstanding the fact that a landlord meeting the standards of section 362(b)(10) is not required to seek bankruptcy court permission to vacate or lift the stay. See, e.g., *Urbanco*, 122 B.R. at 520 (noting superfluity of order modifying stay to permit lessor to proceed in state court); *In re The Depot, Inc.*, Civ. No. 91-33819, 1992 WL 101790 (Bankr. N.D. Ohio Jan. 22, 1992) (granting relief from stay, rejecting contention that continued possession of property was necessary for successful reorganization); *In re Jarman*, 118 B.R. 380 (Bankr. D.S.C. 1989) (granting relief, noting that automatic stay was inapplicable in any event because "there was nothing for the automatic stay to protect" on date of bankruptcy filing); *In re Damianopoulos*, 93 B.R. 3 (Bankr. N.D.N.Y. 1988); *In re Hampton*, 78 B.R. 357, 358 (Bankr. N.D. Ga. 1987) (lease expired on own terms on day before bankruptcy filing, thus, court lifted stay to permit lessor to obtain possession).

⁷⁵⁷ According to the Seventh Circuit, termination of a residential lease on account of default may constitute expiration: "[f]ederal bankruptcy law draws no meaningful distinction between 'expired' and 'terminated' residential leases . . . Instead, the federal law allowing 'unexpired' leases to be assumed calls for a determination whether a lease has ended under state law." *Robinson v. Chicago Housing Authority*, 54 F.3d 316, 319 (7th Cir. 1995). A lease has been terminated for these purposes if 1) the landlord has taken all necessary procedural steps to repossess the premises; and 2) the debtor has no further legal recourse to revive the lease. *Robinson*, 54 F.3d at 321. Applying Illinois law, the *Robinson* court found that its test was clearly satisfied, and a lease had expired, upon entry of a judgment for possession. However, in cases where no judgments for possession were on the docket prior to the bankruptcy filings, courts applying *Robinson* and Illinois law have reached conflicting

the intended goal of reducing costs and litigation for residential landlords. The *in rem* and repeat filing proposals instead will provide tailored relief when needed. Measures other than a statutory landlord exception can effectively curtail this problem. Indeed, even in the Central District of California where the problem is most prevalent, the court's Ad Hoc Committee on Unlawful Detainer reported in January of 1997 that the rate of bankruptcy cases filed to delay eviction had dropped significantly since 1991.⁷⁵⁸

Carving out residential leases from the collective bankruptcy proceeding would have significant consequences to families in bankruptcy as well as their other creditors in the collective bankruptcy proceeding. The fundamental purpose of the

conclusions on what satisfies the Seventh Circuit's termination test. Interpreting the second prong of the test, one court found that even if a tenant has a colorable claim to challenge a landlord's attempt to terminate, termination has occurred once "a tenant has defaulted in payment of rent, the landlord has given whatever demand for rent is required, and the tenant has failed to pay the demanded rent within the required time." *In re Finkley*, 203 B.R. 95, 100 (Bankr. N.D. Ill. 1996). To satisfy the first prong of the test, merely filing an action for possession would suffice, *Id.* at 102. By contrast, another court in the Northern District of Illinois literally interpreted the Robinson test, considered due process implications, and reached the conclusion that in the absence of a judgment, a lease had not "expired" because the Illinois forcible entry and detainer process was not completed and the debtor retained statutory defenses and additional recourse to contest the proceedings. *In re Brown*, No. 95 B 16825, 1995 WL 204913 at *3 (Bankr. N.D. Ill. Dec. 19, 1995). Other courts have attempted to delineate when a residential lease has "expired" or been "terminated" under applicable state laws, separate from the question of whether an individual has an equitable right in the leasehold. *See In re Windmill Farms*, 841 F.2d 1467 (9th Cir. 1988) (lease is terminated no later than when landlord files unlawful detainer proceeding); *In re Mims*, 195 B.R. 472 (Bankr. W.D. Okla. 1996) (under Oklahoma law, lease did not expire for section 365 purposes until writ of assistance was executed and served on debtor); *In re Talley*, 69 B.R. 219, 225 (Bankr. M.D. Tenn. 1986) (lease unexpired until execution of writ of possession under Tennessee law); *In re Morgan*, 181 B.R. 579, 584 (Bankr. N.D. Ala. 1994) (interpreting Alabama law, writ of restitution necessary for expiration of lease, thus lease remained assumable although landlord sought to "terminate" it pre-bankruptcy); *In re Smith*, 105 B.R. 50 (Bankr. C.D. Cal. 1989) (lessee has no property interest in lease and stay does not apply if landlord has obtained judgment for possession); *In re Collier*, 163 B.R. 118 (Bankr. S.D. Ohio, 1993) (lease not assumable under Ohio law after docketing of landlord's state court forcible entry and detainer action); *In re Schewe*, 94 B.R. 938 (Bankr. W.D. Mich. 1989) (although stay applies to lease, under Michigan law, tenancy at will in mobile home provides "cause" for lifting automatic stay). In addition, the anti-forfeiture provisions in some states might preclude a finding of expiration or termination, even when a landlord has obtained a judgment. *See, e.g., Ross v. Metropolitan Dade County*, 142 B.R. 1013, 1015 (S.D. Fla., 1992) (lease did not expire for section 365 purposes under Florida law even if judgment of possession has been entered), *aff'd*, 987 F.2d 774 (11th Cir. 1993); *In re Sudler*, 71 B.R. 780, 785 (Bankr. E.D. Pa. 1987) (under Pennsylvania anti-forfeiture provisions, tenancy not terminated until housing authority obtained actual delivery of real property).

⁷⁵⁸ *See* Report of the United States Bankruptcy Court Central District of California Ad Hoc Committee on Unlawful Detainer and Bankruptcy Mills (January 1997) (rate dropping from over 16% in 1991 to 1% in 1996).

automatic stay is to provide a breathing spell for the debtor while the creditors all are assured that all other creditors are stayed from pursuing the debtor. All creditors are significantly disadvantaged if this aspect of the debtor's financial life is carved out of the bankruptcy process.

The Commission's Recommendation may not solve completely the problem created by fractionalized ownership because some parties question the effect of *in rem* orders on fractionalized interest transferees who recorded the grants before recordation of the bankruptcy court's order, and thus potentially have a due process argument that they are not bound without being brought before the court to bind them. Others do not perceive a constitutional difficulty in binding pre-order transferees; when the court issues the *in rem* order, the pre-order transferees receive constitutionally-adequate notice and a hearing.

Effect of Payment under Chapter 13 Plans

1.5.7 Retention of the "Superdischarge"

Congress should retain 11 U.S.C. § 1328(a), which permits a debtor who completes all payments under the plan to discharge all debts provided for by the plan or disallowed under section 502 of title 11 except for those listed in section 1328(a)(1) - (3).

The Bankruptcy Code presently provides that many debts nondischargeable in Chapter 7 are dischargeable upon completion of a Chapter 13 payment plan. This so-called "superdischarge" allows the discharge of all debts except for family support obligations, drunk driving debts, student loans, criminal restitution, and debts that must be paid on a priority basis in the Chapter 13 plan.⁷⁵⁹ In essence, Chapter 13 allows for certain debts to be "worked off" over three to five years, thus providing an incentive for plan completion by debtors who are able to repay debts in Chapter 13 and making some debts dischargeable only after a substantial repayment period.

Most debtors get no special benefit from the Chapter 13 superdischarge. Whether or not they have nondischargeable debts, they do not receive a Chapter 13

⁷⁵⁹ See 11 U.S.C. § 1328(a)(2), (a)(3) (1994). Student Loan Default Prevention Initiative Act of 1990, Pub. L. No. 101-508, § 3007(b), 104 Stat. 1388; Criminal Victims Protection Act, Pub. L. No. 101-581 §§2(b), 104 Stat. 28 and (3) (overruling Supreme Court's decision in *Pennsylvania Dept. of Pub. Welfare v. Davenport*, 110 S. Ct. 2126 (1990) which held that criminal restitution obligations are dischargeable if debtor completes Chapter 13 plan).

superdischarge because they do not complete their Chapter 13 plans.⁷⁶⁰ Among the debtors who complete plans, the data are insufficient to determine how many otherwise nondischargeable debts are discharged. Parties generally do not litigate dischargeability when the debtor files for Chapter 13 because the superdischarge vitiates the need for that litigation, thus there may never be reliable data to explain how many debtors use the superdischarge provision. Notwithstanding the fact that the majority of debtors do not obtain or have reason to obtain a superdischarge, the issue is somewhat controversial.⁷⁶¹

Some commentators advocate elimination of the superdischarge so that an individual debtor is entitled the same discharge in any chapter. Parties support this position on public policy and pragmatic grounds: if public policy requires a debt to be singled out and excluded from discharge in Chapter 7, the debt should be repaid regardless of whether the debtor undertakes a repayment plan and pays a potentially nominal amount to all creditors.⁷⁶² This argument is bolstered by the fact that under the current system, debtors may be able to discharge a significant nondischargeable obligation by undertaking a payment plan that repays little or no unsecured debt.⁷⁶³ Spreading repayment to all creditors rather than focusing repayment on debts incurred through wrongdoing arguably is not a reasonable trade-off, according to this argument. Although someone with a very large nondischargeable debt will not be

⁷⁶⁰ Even a debtor who receives a “hardship discharge” without completing a plan does not get the benefit of the superdischarge.

⁷⁶¹ See Tax Advisory Committee Final Report (August 1997) (committee divided on three proposals relating to superdischarge); Letter from Heidi Heitcamp, Attorney General for North Dakota and Chair, Bankruptcy and Taxation Working Group, Nat’l Association of Attorneys General (Apr. 4, 1997) (superdischarge enables ill intentioned debtors to discharge debts incurred fraudulently with very little repayment commitment); Patricia L. Barsalou, *Removing Chapter 13 Superdischarge Provision for Tax Debts*, 4 AM. BANKR. INST. L. REV. 494 (1996); see also “American Bankruptcy Institute Roundtable— Consumer Bankruptcy Issues Facing the Commission, American Bankruptcy Institute Journal (July/Aug. 1996) (illustrating strongly disparate views on superdischarge).

⁷⁶² See Memorandum from Commissioner Hon. Edith H. Jones regarding discharge and dischargeability in consumer bankruptcy, (May 20, 1997) (seeing no reason to maintain availability of superdischarge because it “is rarely useful, and when it is, it tends to shield conduct of a sort that society has seen fit to condemn”).

⁷⁶³ See Letter from Francis M. Allegra, Deputy Associate Attorney General, U.S. Department of Justice 6 (June 18, 1997) (unsupportive of fresh start through superdischarge for those who have committed misconduct).

a candidate for the superdischarge because of the debt eligibility limits,⁷⁶⁴ the underlying policy message remains a concern.

The superdischarge has been particularly controversial in the context of tax debts. Some take issue with the notion that Chapter 13 debtors should be excused from paying their entire tax debt.⁷⁶⁵ Taking a different angle on the tax issue, others perceive the superdischarge as a mechanism to provide a manageable re-entry to the tax system, with the end result of being a powerful method of tax collection at low cost to the taxing authorities. A judge from Northern California reported to the Commission that in the bankruptcy cases in San Jose alone, Chapter 13 yielded \$4.2 million for the Internal Revenue Service in 12 months.⁷⁶⁶ The Chapter 13 superdischarge gives people a method to get back into the tax system without facing overwhelming long-past-due liabilities that they could never repay.

Superdischarge supporters argue that the superdischarge is consistent with Congressional intent to build in incentives for debtors to choose Chapter 13 over Chapter 7. If an individual with a nondischargeable debt files for Chapter 13 in the absence of a superdischarge, she will pay all creditors for three to five years and then be required to continue paying nondischargeable debts for years into the future. Because constraints on Chapter 13 plans may preclude the debtor from making full payment of a nondischargeable debt during the life of the plan, and because some courts permit interest to accrue on nondischargeable debts during the time the bankruptcy is pending, debtors sometimes end up owing *more* nondischargeable debt at the end of a plan than at the beginning.⁷⁶⁷ These onerous circumstances hardly provide a reasonable incentive for a debtor to choose Chapter 13. Rather, Chapter 7 would be the far more economically rational route for the debtor. In Chapter 7, the debtor will discharge all other debts and can dedicate future income exclusively to the nondischargeable debt. However, if Chapter 13 provides a superdischarge, a

⁷⁶⁴ 11 U.S.C. § 109(e) (1994) (individual is eligible for Chapter 13 if she has regular income and owes \$250,000 or less in unsecured debt and \$750,000 or less in secured debt).

⁷⁶⁵ See Memorandum from Commissioner James I. Shepard (Apr. 7, 1997) (bankruptcy should not become a tax haven); Patricia L. Barsalou, *Removing Chapter 13 Superdischarge Provision for Tax Debts*, 4 AM. BANKR. INST. L. REV. 494 (1996).

⁷⁶⁶ See, e.g., Hon. Marilyn Morgan, Bankruptcy Judge, N.D. Cal., comments for the National Bankruptcy Review Commission (May 14, 1997) (noting that “bankruptcy judges sometimes joke that in our day jobs we’re tax collectors” and suggesting that it is better to collect part of the taxes than none of the taxes); ABI Consumer Bankruptcy Reform Forum Summary and Report on Options at 7 (undated) (“Chapter 13 has permitted the recovery of substantial tax revenues at low collection cost”).

⁷⁶⁷ Even if debtors do pay the principal on nondischargeable debts in full during the course of a plan, some courts have held that any interest still accruing during the course of the three to five years is not discharged. See discussion on student loan dischargeability earlier in this report.

debtor has an incentive to file for Chapter 13 and remit payment to all creditors for three to five years. Potential abuses of the system are kept in check by the good faith confirmation requirement.

Some people also argue that permitting the Chapter 13 debtor to discharge otherwise nondischargeable debt upon completion of a plan vitiates the need for litigation over whether a particular debt was nondischargeable and provides an additional incentive to make every attempt to complete the plan. If a creditor alleged that a debtor made a false representation, for example, the debtor who can afford litigation expenses could contest the charge. However, the debtor who cannot afford to litigate, but who has a regular income sufficient to fund a Chapter 13 plan, could undertake a Chapter 13 plan. If the debtor completes the plan, the debt will be discharged regardless of the allegation of false representation. If these debts were nondischargeable in Chapter 13, costs to defend nondischargeability actions would be diverted from income otherwise available to creditors, which might make the plan infeasible. This might prevent debtors from contesting even nonmeritorious nondischargeability allegations.

For these reasons, some parties endorsed expansion of the superdischarge for longer plans, enabling additional debts to be dischargeable in Chapter 13, to provide a greater incentive to use Chapter 13.⁷⁶⁸ This change would have restored the superdischarge more to its original form.

In considering the strong views favoring and opposing the superdischarge, the Commission took a middle ground. The Commission declined to change the form of the superdischarge.⁷⁶⁹ By allowing the discharge in Chapter 13 of some debt that would be nondischargeable in Chapter 7, this provision encourages voluntary Chapter 13 filings, more distributions to the creditor body as a whole, and economic rehabilitation of the debtor through improved budget practices and a fresher start. Certain debts paid on a priority basis ahead of other unsecured claims retain their nondischargeable status in all chapters.

⁷⁶⁸ See, e.g., Testimony of National Association of Consumer Bankruptcy Attorneys to the National Bankruptcy Review Commission, *Proposals for Improving the Consumer Provisions of the Bankruptcy Code*, (May 14, 1997) (recommending that there should be enhanced superdischarge for plans that go two years longer than required).

⁷⁶⁹ The Commission's Proposal to eliminate the exception to discharge for educational loans, which also were excepted from Chapter 13 discharge since 1990, also would have an effect on the Chapter 13 discharge.

1.5.8 Debtors who choose Chapter 13 repayment plans should have their bankruptcy filings reported differently from those who do not. Debtors who complete voluntary debtor education programs should have that fact noted on their credit reports.

Federal law permits credit reporting agencies to report Chapter 7 or Chapter 13 filings on debtors' credit reports for up to ten years. Federal law requires credit reports to distinguish between Chapter 7 and Chapter 13 only "if provided by the source of the information."⁷⁷⁰ Moreover, few credit reporters identify debtors who tried to repay or even those who, in fact, completed substantial repayments.⁷⁷¹ One of the ironies of the current bankruptcy system is that debtors who try to repay their debts in Chapter 13 may have worse credit histories than those who quickly discharge debts in Chapter 7.⁷⁷²

Additional and refined information in the credit reporting system would help debtors re-establish credit following bankruptcy and help creditors make more informed credit-granting decisions. The fact that the debtor completed a financial education program also would be useful information for creditors making subsequent lending decisions.⁷⁷³

⁷⁷⁰ Fair Credit Reporting Act § 605(d), 15 U.S.C. § 1681 et seq. (1996); see generally National Consumer Law Center, *Fair Credit Reporting Act Changes Affect Bankruptcy*, NCLC Reports; Bankruptcy and Foreclosures Edition 11 (1996).

⁷⁷¹ See David M. Howe, *How Can Debtors be Motivated to Complete 100% Chapter 13 Plans*, CH. 13 TRUSTEE MESSENGER 1 (February 1996) (acknowledging that there is little recognizable benefit for debtor to struggle to make full repayment if credit reporting agencies continue to report full repayment in Chapter 13 as straight bankruptcy discharge).

⁷⁷² See Karen Gross, *Introducing a Debtor Education Program into the U.S. Bankruptcy System: A Roadmap for Change* (July 7, 1997); Jean Braucher, *Counseling Consumer Debtors To Make their Own Informed Choices- A Question of Professional Responsibility*, 5 AM. BANKR. INST. L. REV. 165, 188 (1997) ("there are many indications that chapter 13 does not bring better credit access, and that chapter 7 may even be preferred by creditors"); Comments of Tom Phillips, Georgia State University, (electronic transmission) (August 9, 1997) (recommending restructuring of consumer credit evaluation and reporting procedures, since under current law, "debtor's credit is equally affected (ruined) regardless of which bankruptcy option is exercised"); Letter from Ramona Winkelbauer, to National Bankruptcy Review Commission, regarding recommendation for bankruptcy reform (Sept. 4, 1997) (recommending that credit reporting agencies be required to report type of bankruptcy case filed by individuals and date of filing. "By 'tarring' all bankruptcy filers with a single label, responsible consumers have difficulties recovering from their need to file. This practice is unfair to those individuals that attempt to reorganize their debts by filing a Chapter 13").

⁷⁷³ Karen Gross, *Introducing a Debtor Education Program into the U.S. Bankruptcy System: A Roadmap for Change*, Submitted to the National Bankruptcy Review Commission (July 7, 1997).

Differential reporting would give debtors a powerful incentive to undertake repayment in Chapter 13 that they might otherwise not attempt.⁷⁷⁴ If the credit reporting and credit granting systems continue to favor Chapter 7 debtors, debtors who do have regular incomes and the means to repay a portion of their debts may be less inclined to choose Chapter 13 for fear of adverse future credit consequences.

Debtors' credit reports also should reflect when debtors do not discharge any debt. For example, if a debtor is repaying debts in a Chapter 13 plan, obtains a high paying job, and decides to dismiss the case and work with his creditors under state law, the debtor should be sure to provide documentation so that the debtor's credit report reflects this fact.

The Commission recommends that the Fair Credit Reporting Act be amended to provide that debtors who choose Chapter 13 repayment plans and make payments have their bankruptcy filings reported differently from those who do not.⁷⁷⁵ This Recommendation does not entail the elimination of the recording of the filing. Rather, the Commission endorses the inclusion of repayment information. The Consumer Bankruptcy Reform Forum of the American Bankruptcy Institute unanimously endorsed this recommended change in credit reporting.⁷⁷⁶ This emphasis on reestablishing a good credit record should not be construed to mean that credit access is more important than savings or learning to live more on a cash basis. Indeed, understanding credit (its benefits, costs and risks), savings and proper budgeting should be key subjects of any educational program that is developed.

1.5.9 Trustees should be encouraged to establish credit rehabilitation programs to help provide better, cheaper access to credit for those who participate in repayment plans.

Partly due to credit reporting, former Chapter 13 debtors historically have experienced difficulty obtaining credit even after completing repayment plans. Restrictions on access to credit are not quite as acute as they once were, but obtaining reasonably priced credit is sometimes harder for Chapter 13 debtors than for Chapter

⁷⁷⁴ See Comments of Tom Phillips, Georgia State University, (electronic transmission) (August 9, 1997) ("I would suspect that many debtors, given the opportunity to rebuild their credit, or even have their credit rating less adversely affected, through reasonable repayment plans to their creditors, would opt for a mutually agreed-upon repayment plan rather than total default.").

⁷⁷⁵ 15 U.S.C. § 1681 et seq (1996).

⁷⁷⁶ ABI Consumer Bankruptcy Reform Forum Summary and Options (Undated).

7 debtors. A few Chapter 13 trustees have instituted credit rehabilitation programs.⁷⁷⁷ These programs, through the use of “credit liaisons,” help Chapter 13 debtors to assess their future credit needs and match that consumer with an appropriate credit grantor to obtain credit at more appropriate rates. A credit rehabilitation program also might help debtors obtain, interpret, and update their credit records.

Credit grantors seem willing to assist consumers with reestablishing their credit through this type of mechanism.⁷⁷⁸ The current programs could provide a model for study as trustees take on this important task.

Trustees may opt to experiment with the level of repayment required for debtors to engage in this program. Very high repayment percentages—from 75-100%—appear to be required.⁷⁷⁹ Other districts may find that debtors who diligently attempt to repay their debts, even if they cannot repay this high a percentage, can be assisted with credit reestablishment as well.

Like with financial education, the uncertain authority to expend funds to run these programs prevents more widespread development of credit rehabilitation. The Commission therefore recommends that this type of program be explicitly recognized. The opportunity to reestablish credit might provide an additional incentive for debtors to not only attempt repayment, but to do their best to complete their plans.

Cited in *Espinoza v. United Student Aid Funds*
No. 06-16421 archived on October 29, 2008

⁷⁷⁷ See, e.g., Frank M. Pees, *Chapter 13 and Chapter 12 Trustee, Southern District of Ohio, Eastern Division, The Affect [sic.] and Scope of Credit Rehabilitation Following the Successful Completion of a Chapter 13 Plan 2* (Dec. 17, 1996) (describing credit re-establishment program); Office of Ray Hendren, Standing Chapter 13 Trustee, Western District of Texas, Austin and Waco Division, Credit Rehabilitation Program *Life After Chapter 13: What Do I Do Now?* (undated); Tom Powers and Tim Truman, Standing Chapter 13 Trustees, Northern District of Texas, Dallas-Fort Worth Division, *The Dallas-Fort Worth Debtor Education/Credit Rehabilitation Handbook* (3d ed. rev. 1996) (citing Frank Pees and Al Olsen, Chapter 13 trustee in San Antonio, as first to have credit liaisons).

⁷⁷⁸ Pees, at 5; *The Thirteen Connection (Creditor/Debtor Attorney Issue)* (Spring 1996) (listing nearly 70 credit grantor participants for Dallas- Fort Worth program).

⁷⁷⁹ Powers and Truman at 14-15.

Annex A

Proposed Statutory Language for 11 U.S.C. § 524(c)

11 U.S.C. § 524(c): An agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under this title is enforceable only if:

- 1) *the agreement was made and has been filed with the court before the granting of the discharge;*
- 2) *the agreement contains a clear and conspicuous statement advising the debtor that the agreement is not required under this title, nonbankruptcy law, or any agreement not in accordance with the provisions of this section, and that the agreement may be rescinded at any time prior to discharge or within 60 days after the agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of such claim;*
- 3) *the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of this title, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, and the agreement stipulates that the lien will be released after the payment of the debt that the debtor has reaffirmed;*
- 4) *the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of their perfection, and the debtor has provided all information requested in the motion for approval of the agreement;*
- 5) *if the debtor is represented by an attorney in negotiations on the agreement, the agreement is accompanied by a declaration or affidavit of the attorney stating that:*
 - (A) *the agreement is voluntary;*
 - (B) *the agreement does not impose undue hardship on the debtor or the debtor's dependents;*
 - (C) *the agreement is, in the view of the attorney, in the best interest of the debtor and the debtor's dependents; and*
 - (D) *the attorney fully advised the debtor of the legal effect and consequences of such an agreement and the consequences of default and alternatives to reaffirmation, such as redemption under section 722 of this title;*

*Cited in Espinoza v. United Student Aid Funds
No. 06-16421 archived on October 29, 2008*

- 6) *the court has held a hearing at its discretion or if required under subsection (d) of this section, reviewed the agreement and its terms and has approved the agreement as being consistent with this section and the provisions of this title; and*
- 7) *the debtor has not rescinded the agreement at any time prior to discharge or within 60 days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of such claim.*

*Cited in Espinoza v. United Student Aid Funds,
No. 06-16421 archived on October 29, 2008*

Annex B
Proposed Statutory Language for 11 U.S.C. § 524(d)

11 U.S.C. § 524(d): In a case concerning an individual, when the court has determined whether to grant or not to grant a discharge under section 727, 1141, 1228, or 1328 of this title, the court may hold a hearing at which the debtor shall appear in person. At any such hearing, the court shall inform the debtor that a discharge has been granted or the reason why a discharge has not been granted. If the debtor seeks to make an agreement of the kind specified in subsection (c) of this section, a hearing on the proposed agreement is not required when:

- 1) the debtor was represented by an attorney in negotiations on the agreement and the debtor's attorney has signed the affidavit as provided in section 524(c);*
- 2) the agreement has been made prior to the date of the debtor's discharge; and*
- 3) a party in interest has not requested a judicial valuation of the collateral that is the subject of the agreement.*

If one or more of the foregoing factors is not satisfied, or in the court's discretion, the court shall conduct a hearing to determine whether the agreement should be approved. At this hearing, the court shall inform the debtor that the agreement is not required under this title, under nonbankruptcy law, or under any agreement not made in accordance with the provisions of subsection (c) of this section. The court shall explain the legal effects and consequences of the agreement and of a default under such an agreement. In addition to meeting all requirements of subsection (c), an agreement can be approved after a hearing only if the court has determined that:

- 1) the agreement is in the best interest of the debtor and the debtor's dependents; and*
- 2) the agreement will not impose an undue hardship on the debtor and the debtor's dependents in light of the debtor's income and expenses.*

Annex C
Proposed Requirements for Motion for Approval of Reaffirmation Agreements

The motion for approval should include the following information:

- *Name of the parties.*
- *Summary terms of new agreement, including the principal amount, the interest rate (APR), the amount of monthly payment, the date on which payments will commence, the total number of payments, the total amount of payments (interest and principal) if paid according to schedule and the date on which the lien will be released, whether payments were in default as of bankruptcy filing, and ways in which terms differ from original agreement.*
- *Description of security, including manufacturer, year, and model if applicable, value of security and the basis for the parties' determination of that value, and current and anticipated use of collateral.*
- *The effect of the proposed reaffirmation on the debtor, including information on the debtor's monthly income and expenses, whether the agreement will impose an undue hardship on the debtor, the reasons for the debtor entering into this agreement, whether the agreement is in the debtor's best interest, and whether the debtor considered the option of redemption under section 722.*
- *Whether the agreement is part of a settlement of litigation on the dischargeability of this debt under section 523 of the Bankruptcy Code.*
- *Whether the debtor was represented by an attorney during the course of the negotiations on the agreement.*
- *A statement of the parties' understanding that the agreement is entirely voluntary and is not required, that the debtor may rescind the agreement at any time prior to discharge or within 60 days after agreement is filed, whichever is later, and that the agreement will be fully enforceable under state law.*
- *Certification of the parties that they have attached the instrument creating the debt and any security interest or lien along with any documents necessary to show perfection of the interest.*

Annex D

State Homestead Exemptions Order of Value as Applicable to Joint Debtors Under Sixty Years of Age with Two Dependents in Non-Rural Region⁷⁸⁰

State	Exemption	Opt-Out?
Florida	Unlimited \$ Amount	Yes
Iowa	Unlimited \$ Amount	Yes
Kansas	Unlimited \$ Amount	Yes
South Dakota	Unlimited \$ Amount	Yes
Texas	Unlimited \$ Amount	No
Minnesota	\$200,000	No
Nevada	\$125,000	Yes
Arizona	\$100,000	Yes
Massachusetts	\$100,000 (\$200,000 if debtor is over 65)	No
North Dakota	\$80,000	Yes
California	\$75,000 (\$100,000 if debtor is over 65)	Yes
Connecticut	\$75,000	No
Mississippi	\$75,000	Yes
New Mexico	\$60,000 (\$30,000 per joint tenant)	No
Alaska	\$54,000	Ambiguous/ Probably Yes
Idaho	\$50,000	Yes
Montana	\$40,000	Yes
Wisconsin	\$40,000	No

⁷⁸⁰ The amounts listed generally do not include “wildcard” exemptions that may be applicable to real property. The acreage limitations imposed in some states also have not been listed. Although reasonable efforts have been expended to ensure the accuracy of this information, consultation with selected state statutes and several secondary sources sometimes provided ambiguous or conflicting accounts of the amounts of the exemptions.

State	Exemption	Opt-Out?
Wyoming	\$40,000 (\$10,000 per "occupant")	Yes
Oregon	\$33,000	Yes
Colorado	\$30,000	Yes
Hawaii	\$30,000	No
New Hampshire	\$30,000	No
Vermont	\$30,000	No
Washington	\$30,000	No
New York	\$20,000	Yes
Indiana	\$15,000 (\$7,500 per debtor)	Yes
Louisiana	\$15,000	Yes
Maine	\$12,500	Yes
Utah	\$11,000 (with spouse and dependents)	Yes
Alabama	\$10,000 (\$5,000 per debtor)	Yes
Georgia	\$10,000 (\$5,000 per debtor)	Yes
Nebraska	\$10,000	Yes
North Carolina	\$10,000	Yes
South Carolina	\$10,000 (if co-owners)	Yes
Missouri	\$8,000	Yes
Illinois	\$7,500	Yes
Tennessee	\$7,500	Yes
West Virginia	\$7,500	Yes
Virginia	\$6,500 (head of household and 3 dependents; can be used for personal property too)	Yes
Kentucky	\$5,000	Yes

Cited in *Espinoza v. United Student Aid Funds*,
No. 06-16429, archived on October 29, 2008

State	Exemption	Opt-Out?
Ohio	\$5,000	Yes
Oklahoma	\$5,000 (unlimited for rural)	Yes
Michigan	\$3,500	No
Arkansas	\$2,500	No
District of Columbia	None (except condo escrow deposits)	No
Delaware	None (but provides \$10,000 lump sum exemption that may be applicable)	Yes
Maryland	None (but provides \$5,500 wildcard exemption for property of any kind)	Yes
New Jersey	No Homestead Exemption	No
Pennsylvania	No Homestead Exemption	No
Rhode Island	No Homestead Exemption	No

Cited in *Espinoza v. United Student Aid Funds*,
No. 06-16421 archived on October 29, 2008