C. PROPERTY EXEMPT FROM SEIZURE

1. Introduction

If you have ever seen a cartoon of a skinny little guy who is broke and wearing only a barrel, you may have wondered why the creditors left the barrel. The law in every state makes at least some property exempt from execution and other legal process so that no debtor can be reduced to absolute destitution. The policy reasons include a desire to avoid results so draconian as to threaten the social fabric of the community (the same rationale forbids taking a pound of flesh). In addition, exemption policies also express a healthy dose of self-interest for those with assets. The concern that a creditor not leave the debtor with so little property that the debtor and the debtor's family will become a charge on the community means that exemption laws are often directed toward making certain that every debtor retains enough basic property to have a chance to get out of the hole and make a fresh start (applicants cannot go to most job interviews nude). Another policy reason for some property exemptions is that some items of personal property, such as clothes, have little resale value for the creditor, but are crucial to the debtor. Although the line between the two is fuzzy, the law distinguishes between seizing property to satisfy a debt and seizing property solely to inflict more pain on the debtor.

When property is defined as "exempt" under state law, general creditors cannot seize it to satisfy their judgments. But consensual agreements, such as mortgages on homes, security interests on cars, or pawnshop possession of jewelry, are not so constrained. As part of the granting of a security interest, the debtor waives the exemptions as to these creditors. This means they are entitled to seize the property for nonpayment of their outstanding loans even when the property is otherwise declared exempt. Note the neat divide among creditor groups: home mortgage lenders, car lenders, and pawnbrokers care little about the scope of exemption laws, while credit card issuers, health care providers, tort victims, and others who cannot get a security agreement in advance feel the teeth in the exemption statutes.

All property not listed as exempt is denominated non-exempt and will be sold by the trustee so that the proceeds can be distributed to the creditors. This is often the general unsecured creditor’s last chance to get paid.
2. A State/Federal System

Every state has exemption laws, although the amount of protection varies widely. Once a debtor files for bankruptcy, federal law pre-empts state collection efforts with the automatic stay, but the question about which property to declare as exempt becomes even sharper. After all, the deal in Chapter 7 is that the debtor will give up all non-exempt property. So what property will federal bankruptcy laws protect?

The 1898 Bankruptcy Act deferred to the states on exemption issues. This meant, for example, that a Texas debtor in bankruptcy could protect whatever a Texas debtor outside bankruptcy could protect, while a Delaware debtor in or out of bankruptcy could protect whatever property Delaware exempted. The fact that Texas and Delaware protected very different items or values was irrelevant.

When the bankruptcy laws were modernized in 1978, many experts believed that it was time to develop uniform national exemptions, but that proposal drew fire from two camps: those in Congress who represented states with much smaller exemptions who thought the uniform proposals were too generous and (you guessed it) those in Congress who represented states with far more generous exemptions who thought the federal exemptions were too stingy. A compromise was born: the federal Bankruptcy Code would establish uniform federal exemptions, but states would be permitted to opt-out of those exemptions, denying their own citizens the benefits of the federal protection when they filed for bankruptcy. 11 U.S.C. §522(b)(2). Thirty-five states have opted out. 14 Collier ¶Intro.03. The constitutionality of opt-out has been challenged, has been affirmed, and has ceased to be a widely disputed issue. See, e.g., In re Lauch, 16 B.R. 162 (Bankr. M.D. Fla. 1981).

We reproduce two sets of state exemption laws. The first is from Texas, and the second is from Delaware.

TEXAS EXEMPTION STATUTES

Texas Property Code Annotated (Vernon 2005)

§41.001. INTERESTS IN LAND EXEMPT FROM SEIZURE

(a) A homestead and one or more lots used for a place of burial of the dead are exempt from seizure for the claims of creditors except for encumbrances properly fixed on homestead property.

(b) Encumbrances may be properly fixed on homestead property for

1. purchase money;
2. taxes on the property;
3. work and material used in constructing improvements on the property if contracted for in writing.

(c) The homestead claimant's proceeds of a sale of a homestead are not subject to seizure for a creditor's claim for six months after the date of sale.
§41.002. DEFINITION OF HOMESTEAD

(a) If used for the purposes of an urban home or as both an urban home and a place to exercise a calling or business, the homestead of a family or a single, adult person, not otherwise entitled to a homestead, shall consist of not more than 10 acres of land which may be in one or more contiguous lots, together with any improvements thereon.

(b) If used for the purposes of a rural home, the homestead shall consist of

1. for a family, not more than 200 acres, which may be in one or more parcels, with the improvements thereon; or
2. for a single, adult person, not otherwise entitled to a homestead, not more than 100 acres, which may be in one or more parcels, with the improvements thereon.

(c) A homestead is considered to be urban if, at the time the designation is made, the property is

1. located within the limits of a municipality or its extraterritorial jurisdiction or a platted subdivision; and
2. served by police protection, paid or volunteer fire protection, and at least three of the following services provided by a municipality or under contract to a municipality
   (A) electric;
   (B) natural gas;
   (C) sewer;
   (D) storm sewer; and
   (E) water.

(d) The definition of a homestead as provided in this section applies to all homesteads in this state whenever created.

§41.003. TEMPORARY RENTING OF A HOMESTEAD

Temporary renting of a homestead does not change its homestead character if the homestead claimant has not acquired another homestead.

§42.001. PERSONAL PROPERTY EXEMPTION

(a) Personal property, as described in Section 42.002, is exempt from garnishment, attachment, execution, or other seizure if

1. the property is provided for a family and has an aggregate fair market value of not more than $60,000, exclusive of the amount of any liens, security interests, or other charges encumbering the property; or
2. the property is owned by a single adult, who is not a member of a family, and has an aggregate fair market value of not more than $30,000, exclusive of the amount of any liens, security interests, or other charges encumbering the property.

(b) The following personal property is exempt from seizure and is not included in the aggregate limitations prescribed by Subsection (a)

1. current wages for personal services, except for the enforcement of court-ordered child support payments;
(2) professionally prescribed health aids of a debtor or a dependent of a debtor; and

(3) alimony, support, or separate maintenance received or to be received by the debtor for the support of the debtor or a dependent of the debtor.

(c) This section does not prevent seizure by a secured creditor with a contractual landlord's lien or other security in the property to be seized.

(d) Unpaid commissions for personal services not to exceed 25 percent of the aggregate limitations prescribed by Subsection (a) are exempt from seizure and are included in the aggregate.

§42.002. PERSONAL PROPERTY

(a) The following personal property is exempt under Section 42.001(a)

(1) home furnishings, including family heirlooms;
(2) provisions for consumption;
(3) farming or ranching vehicles and implements;
(4) tools, equipment, books, and apparatus, including boats and motor vehicles used in a trade or profession;
(5) wearing apparel;
(6) jewelry not to exceed 25 percent of the aggregate limitations prescribed by Section 42.001(a);
(7) two firearms;
(8) athletic and sporting equipment, including bicycles;
(9) a two-wheeled, three-wheeled, or four-wheeled motor vehicle for each member of a family or single adult who holds a driver's license or who does not hold a driver's license but who relies on another person to operate the vehicle for the benefit of the nonlicensed person;
(10) the following animals and forage on hand for their consumption
    (A) two horses, mules, or donkeys and a saddle, blanket, and bridle for each;
    (B) 12 head of cattle;
    (C) 60 head of other types of livestock; and
    (D) 120 fowl; and
(11) household pets.

(b) Personal property, unless precluded from being encumbered by other law, may be encumbered by a security interest under Section 9.203, Business & Commerce Code, or Subchapter F, Chapter 501, Transportation Code, or by a lien fixed by other law, and the security interest or lien may not be avoided on the ground that the property is exempt under this chapter.

§42.003. DESIGNATION OF EXEMPT PROPERTY

(a) If the number or amount of a type of personal property owned by a debtor exceeds the exemption allowed by Section 42.002 and the debtor can be found in the county where the property is located, the officer making a levy on the property shall ask the debtor to designate the personal property to be levied on. . . .
§42.005. CHILD SUPPORT LIENS

Sections 42.001, 42.002, and 42.0021 of this code do not apply to a child support lien established under Subchapter G, Chapter 157, Family Code.

§42.0021. ADDITIONAL EXEMPTION FOR CERTAIN SAVINGS PLANS

(a) In addition to the exemption prescribed by Section 42.001, a person’s right to the assets held in or to receive payments, whether vested or not, under any stock bonus, pension, profit-sharing, or similar plan, including a retirement plan for self-employed individuals, and under any annuity or similar contract purchased with assets distributed from that type of plan, and under any retirement annuity or account described by Section 403(b) or 408A of the Internal Revenue Code of 1986, and under any individual retirement account or any individual retirement annuity, including a simplified employee pension plan, and under any health savings account described by Section 223 of the Internal Revenue Code of 1986, is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract, or account does not qualify under the applicable provisions of the Internal Revenue Code of 1986. A person’s right to the assets held in or to receive payments, whether vested or not, under a government or church plan or contract is also exempt.

(b) Contributions to an individual retirement account, other than contributions to a Roth IRA described in Section 408A, Internal Revenue Code of 1986, or an annuity that exceed the amounts deductible under the applicable provisions of the Internal Revenue Code of 1986 and any accrued earnings on such contributions are not exempt. Amounts treated as qualified rollover contributions are treated as exempt amounts under Subsection (a).

§1108.0531. EXEMPTIONS FOR CERTAIN INSURANCE AND ANNUITY BENEFITS

(a) Except as provided by Section 1108.053, this section applies to any benefits, including the cash value and proceeds of an insurance policy, to be provided to an insured or beneficiary under:

(1) an insurance policy or annuity contract issued by a life, health, or accident insurance company, including a mutual company or fraternal benefit society; or

(2) an annuity or benefit plan used by an employer or individual.

(b) Notwithstanding any other provision of this code, insurance or annuity benefits described by Subsection (a):

(1) inure exclusively to the benefit of the person for whose use and benefit the insurance or annuity is designated in the policy or contract; and

(2) are fully exempt from:

(A) garnishment, attachment, execution, or other seizure;
(B) seizure, appropriation, or application by any legal or equitable process or by operation of law to pay a debt or other liability of an insured or of a beneficiary, either before or after the benefits are provided; and
(C) a demand in a bankruptcy proceeding of the insured or beneficiary.

§1108.053. EXCEPTIONS TO EXEMPTIONS

The exemptions provided by Section 1108.051 do not apply to:
(1) a premium payment made in fraud of a creditor, subject to the applicable statute of limitations for recovering the payment;
(2) a debt of the insured or beneficiary secured by a pledge of the insurance policy or the proceeds of the policy; or
(3) a child support lien or levy under Chapter 157, Family Code.

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DELAWARE EXEMPTION STATUTES


EXEMPT PROPERTY

(a) Every person residing within this State shall have exempt from execution or attachment process, or distress for rent, the following articles of personal property: The family Bible, school books and family library, family pictures, a seat or pew in any church or place of public worship, a lot in any burial ground, all the wearing apparel of the debtor and the debtor's family.

(b) In addition to the articles specifically named in subsection (a) of this section, each person residing in this State shall have exempt the tools, implements and fixtures necessary for carrying on his or her trade or business, not exceeding in value $75 in New Castle and Sussex Counties, and $50 in Kent County.

(c) All sewing machines owned and used by seamstresses or private families, shall be exempt from levy and sale on execution or attachment process and also from distress and sale for rent. This provision shall not apply to persons who keep sewing machines for sale or hire.

(d) All pianos, piano playing attachments and organs leased or hired by any person residing in this State, shall be exempt from levy and sale on execution or from distress for rent due by such person so leasing or hiring any such piano, piano playing attachment, or organ in addition to other goods and chattels exempt by law. The owner of any such piano, piano playing attachment or organ or such owner's agent, or the person so leasing or hiring the same shall give notice to the landlord or the landlord's agent that the instrument is hired or leased.
§4913. EXEMPTION AND ATTACHMENT OF WAGES

(a) Eighty-five percent of the amount of the wages for labor or service of any person residing within the State shall be exempt from mesne attachment process and execution attachment process under the laws of this State; but such limitation shall be inapplicable to process issued for the collection of a fine or costs or taxes due and owing the State.

(b) On any amount of wages due, only 1 attachment may be made. Any creditor causing such attachment to be made shall have the benefit of priority until the judgment with costs for which the attachment was made has been paid in full.

(c) Wages shall include salaries, commissions and every other form of remuneration paid to an employee by an employer for labor or services, but shall not include payment made for services rendered by a person who is self-employed.

§4915. EXEMPTION OF RETIREMENT PLANS

(a) In addition to the exemptions provided in § § 4902 and 4903 of this title, there shall be exempt from execution or attachment process assets held or amounts payable under any retirement plan.

(c) A participant or beneficiary of a retirement plan is not prohibited from granting a valid and enforceable security interest in the participant's or beneficiary's interest under the retirement plan to secure a loan to the participant or beneficiary from the plan, and the right to assets held in or to receive payments from the plan is subject to execution and attachment for the satisfaction of the security interest or lien granted by the participant or beneficiary to secure the loan.

(f) “Retirement plan” means any retirement or profit sharing plan that is qualified under §401, §403, §408, §408A, §409, §414 or §457 of the Internal Revenue Code of 1986 [26 U.S.C. §401, §403, §408, §408A, §409, §414 or §457], as amended.

§2725. EXEMPTION OF PROCEEDS, LIFE INSURANCE

(a) If a policy of insurance, whether heretofore or hereafter issued, is effected by any person on his/her own life, or on another life, in favor of a person other than himself/herself, or, except in cases of transfer with intent to defraud creditors, if a policy of life insurance is assigned or in any way made payable to any such person, the lawful beneficiary or assignee thereof, other than the insured or the person so effecting such insurance or executors or administrators of such insured or the person so effecting such insurance, shall be entitled to its proceeds and avails against the creditors and representatives of the insured and of the person effecting the same.... [Group and health insurance and annuities are also exempted, absent an intent to defraud creditors.]
§2355. ASSIGNMENT OF COMPENSATION PROHIBITED; EXEMPTION FROM CREDITORS’ CLAIMS; CHILD SUPPORT EXCEPTION

Except for attachments pursuant to child support orders entered under Chapters 4, 5 or 6 of Title 13, claims or payment for compensation due or to become due under this chapter shall not be assignable and all compensation and claims therefor shall be exempt from all claims of creditors.

The opt-out provision offers yet another place for ironic observation. Texas, with its generous exemptions, did not opt out, leaving a Texan to choose between an unlimited homestead and $30,000 in value in other property and a federal homestead exemption of $16,150 and about $16,000 or so in other property. The choice can sometimes be valuable, however. For example, the federal exemptions allow for an $850 wildcard exemption that could be used to protect cash in a checking account (more realistically, a tax refund), while the Texas exemptions protect no cash. For someone with no home and only modest assets, being able to protect a few hundred dollars in cash would make the federal exemptions more attractive than the state exemptions.

While Texas lets its citizens choose between federal and state exemptions, Delaware says no. The state opted out of the federal exemptions. To make its views on bankrupt families a little clearer, Delaware added another provision:

DELAWARE EXEMPTION STATUTES
10 Del. C. §4914 (1999)

§4914. EXEMPTIONS IN BANKRUPTCY AND INSOLVENCY

(a) In accordance with §522(b) of the Bankruptcy Reform Act of 1978 (11 U.S.C. §522(b)), in any bankruptcy proceeding, an individual debtor domiciled in Delaware is not authorized or entitled to elect the federal exemptions as set forth in §522(d) of the Bankruptcy Reform Act of 1978 (11 U.S.C. §522(d)) and may exempt only that property from the estate as set forth in subsection (b) of this section.

(b) In any federal bankruptcy or state insolvency proceeding, an individual debtor domiciled in Delaware shall be authorized to exempt from the bankruptcy or insolvency estate, in addition to the exemptions made in §4915 of this title, property having an aggregate fair market value of not more than $5,000.

(c) This section shall apply separately with respect to each debtor in a joint proceeding.

The latest amendments to Section 4914 were signed by the governor on May 22, 1997, making it clear that Delaware’s limited exemptions were not a matter of oversight, but of deliberate choice. The fact that Delaware changes its permissible
exemptions when a debtor files for bankruptcy might mean that the state statute has impermissibly encroached on the federal bankruptcy powers. The federal exemptions allow for opt-out, but they do not invite state legislatures to select one set of exemptions to operate at state law and a different set under the federal bankruptcy laws. So far, we have seen no challenges to the Delaware laws. Perhaps debtor advocates are worried that the legislature will respond by imposing the $5,000 cap both in and out of bankruptcy.

The federal exemptions cover a wide variety of property, including payments from crime reparations laws and unmatured life insurance. §522(d). As part of the 2005 Amendments, Congress expanded the federal exemption for retirement funds regardless of whether the debtor lived in a state that opted out of the federal exemptions. §522(b)(3)(C), (d)(12). The action is a little bit of a belt-and-suspenders move since most of those retirement accounts were not property of the estate anyway because they had spendthrift trust provisions. §541(c). To the extent the federal exemptions are limited to specific dollar amounts, such as the $2,950 exemption in a car, those amounts are adjusted every three years for inflation. §108(d), (e).

All states and the federal government must wrestle with the same set of issues about what a debtor can keep and what a creditor can demand that the debtor give up to satisfy unpaid debts. Every set of exemption statutes has at least some provisions that are tied to specific kinds of property—household goods, homesteads, rights to receive disability payments, and so on.

Exemptions amounts may range from non-existent to unlimited. Nowhere is that disparity more evident (or more hotly debated) than with homesteads. The Texas statute cited above limits a homestead in terms of acreage. So long as the home is on less than ten acres in a city or 200 acres in the country, the debtor is entitled to exempt that property from attachment, regardless of its dollar value. At the other end of the spectrum is Delaware with no homestead exemption at all. A homeowner in Delaware cannot keep even the most modest home if the debtor has built up any equity. Federal exemptions are somewhere in between, setting a dollar value on the homestead for each debtor—an amount that can be doubled for married couples filing jointly.

According to our empirical research, about half of the families who file for bankruptcy won’t care about the homestead exemption because they are not homeowners. Some have never owned a home, but about 12.2 percent of the non-homeowners had already lost their homes for financial reason before they filed for bankruptcy. No homestead exemption will help either group.

As generous as they are, the Texas exemptions add no special protection for renters to match the protection available to homeowners. By comparison, the federal statutes give a special boost. Anyone who does not claim a homestead exemption under section 522(d)(1) is permitted to claim half the value of the unclaimed homestead exemption in any property at all under section 522(d)(8). Why half? It looks like another perfect compromise—halfway between those who believed only homes should be protected and those who believed that renters should have the same chance to protect value, whether it is in a home or checking account.

Not all homeowners in bankruptcy need to use a homestead exemption. When a home mortgage—or a second mortgage or even third mortgage—is as large as the total value of the property, then the debtor has no equity to protect. Our study of 2001 debtors found that about 30 percent of the homeowners had no equity in their houses. We found that, on average, a debtor family that owns a home reports a mortgage-to-
value ratio of about .94, meaning that the mortgage is equal to about 94 percent of the value of the house.

For those debtors who have some equity in their homes, the homestead exemption becomes a matter of critical focus, the determinant of whether they can keep their homes or will be forced to give up the lives they have built. The median amount of home equity (home value minus mortgage) in our 2001 sample was about $12,000, which means half the debtors had more equity than that and half had less. In many cases, of course, a house estimated to have a small equity like $12,000 would not bring more than the mortgage amount in a forced sale. Given these figures, the $16,150 in home equity exemption in the federal exemptions ($32,300 for a couple) is of great importance to a large proportion of the debtors who own homes. §522(d)(1). The homestead exemption is further explored in the next section of this chapter.

Other exemption types carry much the same punch but for fewer debtors. For an office worker with no tools of the trade, the state and federal exemptions for tools are irrelevant. But for a plumber trying to hold on to the tools that make it possible for him to earn a living, the availability of an exemption is a critical part of the protection offered in the bankruptcy system.

It should be noted that both Texas and Delaware, like most states, exempt various domestic support obligations and liens from the exemption laws, so that child support, for example, may be enforced by the seizure of otherwise exempt property. Certain other exemptions from exemptions may also apply in some states.

3. Classification of Property

Because exemption statutes are often written to exempt only listed types of property, disputes between debtors and creditors frequently center on classification issues. Debtors argue that the property they intend to keep fits within the statutory classifications, and judgment creditors, who are permitted to reach only non-exempt property, argue that the property does not.

The following cases arose in bankruptcy, a sharp reminder that although the exemptions the debtor may claim are creatures of state law, the federal bankruptcy courts will be called on to determine their meaning—often more regularly than the state courts themselves.

In re JOHNSON

DEITZ, Bankruptcy Judge.

Is a bus a bus, or is it a car?

Reluctantly we conclude that it is a car.

Bankruptcy petitioner, Theodore Roosevelt Johnson, Sr., has claimed as exempt his 1969 Dodge bus. The bus has a seating capacity of 60 passengers. Upon it are occasionally transported members of Johnson's church congregation.

The trustee vehemently objects. He points to the state exemption statute, KRS 427.010, which in pertinent part permits the exemption of "one motor vehicle and its necessary accessories, including one spare tire, not exceeding $2,500 in value. . . ."
The trustee patiently explains that the legislature intended the term "motor vehicle" to be synonymous with "automobile."

Enacted in 1980, the statute excluded earlier statutory limits upon the uses to which a motor vehicle might be put, so we must cast altogether aside the trustee's concern with the voluminous seating capacity of the behemoth. The record is silent on the size of the petitioner's family and their transportation needs.

Is a Moped a motor vehicle? What would the licensing arm of the state Department of Transportation say to the contention that a bus is not a motor vehicle? What would Gertrude Stein have to say about what a motor vehicle is?

Such rhetorical questions having been considered, we are bold to say that a bus is a motor vehicle.

In our dialectic, during this era of motorized evolution, we are inclined to regard the "bus" and the "automobile" as species of the genus, "motor vehicle."

This Bankruptcy Court is answerable to an appellate forum of literal bent. That is good, for it gives us guidance and certainty in ascribing to the legislature the ability to express its intent in clear, simple, precise English.

As this trustee will recall, District Judge Thomas Ballantine, in reviewing a decision of this court, recently held that a statutory 15-day limitation upon the recording of chattel mortgages imposed a recording limitation not of indeterminate length, as was contended, but a limitation of 15 days.

Guided by that clarity of perception, we find with conviction that a motor vehicle is a motor vehicle, and not necessarily an automobile. We expressly reserve, until it is properly presented, any consideration of the reverse proposition that an automobile is neither a bus nor a motor vehicle.

Abundantly confident that this opinion will find its way alongside Marbury v. Madison and McCulloch v. Maryland in the lasting library of legal logic, it is hereby ordered that Theodore Roosevelt Johnson, Sr., is entitled to the claimed exemption, and the trustee shall comport his activities accordingly in administration of the estate.

The only near competitor to Johnson as our favorite classification case is In re Hall, 169 B.R. 732 (Bankr. N.D. Okla. 1994), in which the debtor claimed a tractor-lawnmower exempt under the category "household furniture." The Oklahoma bankruptcy court held that lawnmowers are not furniture. One of us was surprised.

In the next case, the property in dispute is of considerable value.

In re PIZZI
153 B.R. 357 (Bankr. S.D. Fla. 1993)

Robert A. Mark, Bankruptcy Judge.

April 19, 1985, was a good day for Kathleen Pizzi. The Connecticut State Lottery drew the numbers on her ticket converting her one dollar purchase into a prize worth $3,202,624.20. Despite her good fortune, Ms. Pizzi incurred substantial debt in the years that followed, ultimately resulting in the filing of this Chapter 7 case.
Ms. Pizzi seeks to discharge her substantial debts without giving up her right to receive twelve more annual payments of $128,105.17 from Connecticut to complete the twenty (20) year payout of her prize. She claims that this income stream is an annuity contract protected from creditors under Florida law and thus an exempt asset in this bankruptcy case. Her exemption claim is challenged by the Trustee and two bank creditors. The Court sustains the objections. The unpaid lottery winnings are nonexempt assets which must be liquidated to pay creditors.

Based upon the stipulation of the parties and the documents in the record, the relevant facts are as follows:

3. The lottery winnings had a present money value of $1,003,747.79 after payment of her first of twenty installments.

4. The prize was payable in twenty (20) annual installments each in the amount of $160,131.21. After withholding tax, the net payment to Ms. Pizzi each year is $128,105.17.

5. On or about April 19, 1985, the State of Connecticut, Division of Special Revenue, purchased an annuity contract from Met Life bearing certificate number 512 for the sum of $1,003,747.79, for the benefit of Kathleen G. Pizzi.

[5. Stipulated Documents] c. A letter dated April 22, 1985, from the State of Connecticut to Ms. Pizzi officially confirming her winning ticket, enclosing her first check for $128,105.17 and advising her that the State Comptroller would be issuing checks in the like amount to her each year for the next 19 years;

d. The annuity contract issued by Met Life. The State of Connecticut, Division of Special Revenue is named as the "Owner" and "Beneficiary" of the Contract.

9. The Debtor's schedules reflect secured claims in the amount of $828,540.07, unsecured priority claims in the amount of $28,000 and general unsecured claims of $380,119.29. The unsecured claims include Connecticut National's $310,518.28 claim.

[The debtor's other assets] consist solely of $4,000 realized from the sale of a vehicle (CP #65 — Trustee's Report, November 23, 1992).

DISCUSSION

The sole issue in this case is whether the proceeds from the lottery winnings are exempt from the claims of creditors under Florida law.

C. The Payments from the State of Connecticut to Ms. Pizzi Are Not Annuity Payments

The Court must alternatively consider whether the yearly payments paid by the State of Connecticut to Kathleen Pizzi should be considered annuity payments. Does this income stream fall within the definition of annuity under Fla. Stat. §222.14?

The definition of an annuity under Florida law has been recently addressed by the Florida Supreme Court. In re McCollam, 612 So. 2d 572 (Fla. 1993). McCollam involved another tragic automobile accident and the damage settlement stemming from the wrongful death action. Under the terms of the agreement Travelers Insurance Company purchased an annuity contract. The debtor was listed as the beneficiary and payee under the contract. Travelers' debt obligation to the debtor is liquidated and discharged by the amount of each successive annuity payment.
In a four to three decision, the Florida Supreme Court employed the plain meaning doctrine and concluded that, on its face, the statute applies to all annuity contracts. The Court rejected the dissent's resort to legislative history stating that "legislative history is irrelevant where the wording of a statute is clear." Utilizing a broad definition of "annuity," the Court concluded that the contract at issue was within the statutory exemption.

In *McCollam* the court analyzed an annuity contract purchased to settle a personal injury lawsuit. Although the reasons for purchasing the annuity are unique, the facts remain that what was bought was an annuity in the name of the debtor. Here, the income stream flowing directly to the Debtor is not an annuity at all. The monies are prize winnings stemming from the winning of the lottery. The Connecticut Lottery regulations never refer to the winnings as proceeds of an annuity, and the winner is never referred to as the beneficiary or payee of an annuity.

**POLICY ARGUMENTS**

The Debtor argues that exemptions should be liberally construed in favor of debtors. . . .

The banks argue that §222.14 is intended to protect annuity contracts which provide life insurance and retirement benefits. To broadly interpret the statute and allow lottery winnings to be claimed as exempt would, they argue, be unfair and beyond the intended purpose of the exemption.

This Court agrees that it would be inequitable for a Debtor to obtain loans in reliance upon her lottery winnings and then discharge these obligations without turning over the winnings to her estate. The exemption laws were not intended to protect instant millionaires from paying their legitimate debts.

. . . Despite strong policy arguments to include lottery winnings in the estate, the Court's decision today does not and could not rest on policy grounds given the Florida Supreme Court's broad interpretation of §222.14 in *McCollam*. Inequitable or not, if a lottery winner is specifically named as a beneficiary of an annuity contract purchased to fund a state's obligations, the winnings may be exempt.

. . . By separate order, the Court will sustain the objections to the Debtor's claim of exemption filed by the Trustee, the Bank of New York and Connecticut National.

As these cases demonstrate, whenever a statute exempts property by classification, rather than by total dollar value, there will be hard questions at the margin about what property does and what property does not fall within the classification. The legislator has a mythical typical family in mind, but reality is seldom so neat.

**4. Valuation of Exempt Property**

In addition to determining whether property claimed as exempt fits within the allowed categories, it is often necessary to determine whether the property fits within the permitted valuations as well. The following cases illustrate the disparity in courts' resolutions of these disputes.
In re WALSH

WHELAN, Bankruptcy Judge.

This matter came before the Court for hearing on an application for appraisal, pursuant to Local Bankruptcy Rule 24(b), filed by the trustee in bankruptcy, Robert O. Tyler, Esq., and the opposition thereto, filed by the debtor, Charles J. Walsh. Although an application for an appraisal by the trustee may ordinarily be granted without a hearing, a dispute has arisen in the instant case with respect to the standard of valuation to be applied to property claimed by the debtor as exempt under 11 U.S.C. 522. The trustee's application seeks an appraisal of these assets at fair market value, rather than liquidation value, on which basis a previous appraisal was made.

There is no dispute as to the "disinterestedness" or qualifications of the appraiser....

The court ... is of the opinion that the application in this case, although not captioned as an objection to the claimed exemptions, is, in substance, an objection, because it calls into question the amounts claimed as exempt on the basis of their valuation. If the assets claimed as exempt exceed the monetary limits set forth in 522(d), then only to that extent, they are non-exempt assets. . . .

"Value," for the purposes of the exemption section, is defined as "fair market value as of the date of the filing of the petition." [11 U.S.C. §522(a)(1).] This definition governs the meaning of "value" only for purposes of this section, and differs from the definition applicable in other sections of the Code. [11 U.S.C. §102(8).] The legislative history does not elaborate on the purpose or significance of this specific definition in Section 522.

The rules of statutory construction dictate that, where the language of a statute is clear, the Court should interpret it according to its "plain meaning." However, a statute is to be interpreted as a whole, and one provision should not be construed in a manner inconsistent with the whole.

Thus, in construing the meaning of the definition of value in Section 522, the Court must look to the usual and accepted meaning of "fair market value," while taking into consideration the liquidation context and the goals of the Code as a whole. Fair market value has been defined as the "price at which a willing seller and a willing buyer will trade." Fair market value "assumes agreement between owner willing but not obliged to sell for cash and buyer desirous but not compelled to purchase." Black's Law Dictionary 716 (4th Ed. 1968). In ascertaining fair market value, "there should be taken into account all considerations that fairly might be brought forward and reasonably be given substantial weight in bargaining." Karlson v. U.S., 82 F.2d 330, 337 (8th Cir. 1936), citing Olson v. U.S., 292 U.S. 246, 257(1934).

The definition is "not invariable," but "varies with the circumstances surrounding a given object and situation to which it is sought to apply the term." McDougall Co. v. Atkins, 201 Tenn. 589, 301 S.W.2d 335, 337 (1957) (valuation for sales tax purposes, of air ducts installed in buildings, held not equivalent to scrap value). "A valuation is always a stage in some proceeding which has a practical purpose." McCormick, The Law of Damages, §43 at 163 (1935). Thus, the Courts
have viewed fair market value in the context in which the valuation question has arisen. 2

In light of the rules of statutory construction, this contextual approach to the definition of "fair market value" appears particularly appropriate where the term appears in a statute.

In the instant case, the trustee argues that the §522(a)(1) definition of value should be construed literally and independently of the Ch. 7 context, rather than as "liquidation value." Counsel for the debtor, on the other hand, argues that the definition of "market" on the day a bankruptcy petition is filed, is, invariably, an eventual bankruptcy sale. Thus, he submits that the assets claimed as exempt should be appraised according to their liquidation value.

Inasmuch as the purpose of valuation under the exemption provisions is ultimately to determine whether such property is subject to liquidation by the trustee because it is in excess of specified monetary amounts, the Court believes that the term "fair market value," as it is used to define "value" in Section 522, must be interpreted in the liquidation context in a Chapter 7 case. 3

Therefore, the Court finds that, in the instant case, "fair market value," as the term is used in Section 522, is equivalent to liquidation value. Accordingly, the trustee's application for an appraisal is denied.

2. The term's meaning in the exemption provision would thus not necessarily be consistent with its meaning in the determination of insolvency under the Old Act, for instance. Cf. 1 Collier on Bankruptcy, paragraph 1.19 at 122-125 (14th ed).

3. This is illustrated by the following hypothetical situation. A debtor owns an automobile, free and clear of any lien, which, if sold under ordinary market conditions — the willing buyer and willing seller approach to the fair market value — would yield $2,000. The debtor, pursuant to 11 U.S.C. 522(d)(2), claims the auto as exempt to the extent of $1,200. If the Court deems the asset to be worth $2,000 because of a theoretical fair market value standard and authorizes a sale by the trustee, the resulting sale, of necessity, in the actual forced sale setting, may bring only $1,200 — the amount which the debtor is entitled to claim as exempt. Obviously, in this situation, no benefit to the estate is gained because the only amount realized is subject to the debtor's claim of exemption. Accordingly, the only conclusion that can be logically drawn is that fair market value, as defined in 522(a), is subject to bankruptcy market conditions.
In re MITCHELL  
103 B.R. 819 (Bankr. W.D. Texas 1989)

DECISION AND ORDER ON OBJECTIONS TO CLAIM OF EXEMPT PROPERTY

Leif M. CLARK, Bankruptcy Judge.

A hearing was held before this court on January 11, 1989, regarding the objections of First City National Bank of Austin to the claimed exemptions of the debtors in this case. The objections focused on the debtors' claim to certain jewelry, including in particular a 6.18 carat diamond ring worn rather regularly by Mrs. Mitchell.

The bulk of the controversy centers on the valuation issue. First City says that this court should simply apply a fair market standard of valuation, consistent with the language used in both section 522 of the Bankruptcy Code ("Code") and section 42.001 of the Texas Property Code. The debtor argues for applying a distress or liquidation valuation, in keeping with the fresh start policy of the Code and in recognition of the asserted realities of bankruptcy that, if the property is not retained by the debtor, it will realize for the estate only what the Chapter 7 trustee can get for it anyway, which is generally a liquidation price.

BACKGROUND FACTS

The evidence focused largely on the valuation issue, though some evidence regarding use and intent to use was also submitted. All of the jewelry pieces, including the 6.18 carat diamond ring, are worn regularly by the debtors (indeed, some of the pieces show a substantial amount of wear, detracting from their value). The debtors acquired all of the pieces for the purpose of wearing them, and many of the pieces included such comparatively utilitarian items as watches and earrings.

The evidence suggested mixed motives for acquiring the 6.18 carat diamond ring. On the one hand, the ring was purchased on the occasion of the Mitchells' twenty-fifth wedding anniversary. Mr. Mitchell had not been able to buy his wife much of an engagement ring when they were wed, so this was actually her first real wedding diamond. He paid in excess of $30,000 for the ring in 1978, evidently believing the ring to be a good investment at the time.

. . . The court finds the testimony regarding use and intent to be credible and believes that, notwithstanding a clear investment purpose, expressed in both the size of the diamond and the testimony of Mr. Mitchell, other factors, such as continuous wear and sentimental attachment, carry considerable weight sufficient to qualify the ring as "clothing reasonably necessary for the family."

The valuation testimony differed dramatically. First City's expert assigned an "estate value"4 to the 6.18 carat diamond ring, of approximately $6,800.00 per carat, or $42,024.00. He gave the ring a fair market value of $36,000.00. The debtors' expert (the same man who wanted to buy the ring and who had also originally sold it to Mr. Mitchell) said that, in situations such as this, where the debtor had to sell, he would offer no more than $7,800.00 for the ring, as that would take into account the risk he

4. The estate value is what a jewelry company would have to pay on the diamond market to acquire the stone, as opposed to the retail market, which is what one would ask the customer to pay for the item.
would be taking in trying to re-market the ring to someone else. The latter value represented little or no "holding period" while the former assumed a reasonable exposure to the market of a period of months. The court finds both witnesses' testimony credible insofar as they are consistent with an assumed valuation standard, leaving the court to decide which valuation standard should be adopted.

The debtors will be hard-pressed to keep the 6.18 carat diamond ring should this court find that the fair market valuation standard controls. The debtor has already claimed household goods worth $12,000.00 (by stipulation, which this court accepts), other jewelry of $4,500.00, other clothing of $1,000.00, and the cash surrender value of a life insurance policy ($30,857.00). If the diamond ring is indeed worth $36,000.00, the debtors will be forced to choose between the ring and their household furnishings.  

The argument advanced in favor of the fair market valuation standard ("FMV") is that both the state and federal exemption statutes expressly stipulate to that standard. . . .

The debtor appeals to logic, public policy, and practicality. The most elegant expression of the argument is found in In re Walsh, noted above. There, then Bankruptcy Judge Roger Whelan, after acknowledging the express language of the statute, fled to the panoply of canons of statutory construction for relief from the plain meaning of the statute. . . .

. . . Judge Whelan then added, as illustration, that using fair market value in the traditional sense only hurts the debtor without augmenting the return to creditors. . . .

. . . It is technically incorrect to say that Walsh favors the use of a liquidation valuation per se. The case instead encourages a focus on the applicable market when one speaks of "fair market value." Urging that the applicable market is the one available to a bankruptcy trustee, the values generated in that market will reflect the sale circumstance by being somewhat depressed.

There are a number of difficulties with this position, however. The argument is essentially circular and turns the generally accepted definition of fair market value on its ear. ... By focusing on "market," Walsh ignores the "fair" in fair market value. . . .

There is also another (and what I consider to be a more fundamental) difficulty with the Walsh position, and that is that it is out of step with what I conceive to be the overriding function of the "cap" which Texas places on personal property exemptions. Section 42.002 of the Property Code sets out what Texas finds to be the "approved list" of items which Texans should be allowed to retain, no matter how much they owe creditors. Some of these items assure the survival of the individual or the family in some station above abject poverty. 7 Thus, we will not let

5. First City points out that, even at the debtors' value, the exemptions claimed exceed the $30,000 cap by $26,157.00 . . .

7. Our exemption laws attempt to strike a balance between the rights of creditors and the survival of debtors. They do not assure the preservation of a debtor's station in life, but rather act as a "safety net" to prevent debtors and their families from being left destitute, wards of the state as a result of creditor collection activity. Leva, 96 B.R. at 728. Exemptions are in fact a limit on a creditor's right to satisfaction of its claim out of the debtor's assets. The limitations are imposed for reasons of public policy. There is no public policy served in preserving the lifestyles of the rich and bankrupt.
creditors take away the debtor's means of transportation in this, the largest state among the lower forty-eight. . . .

In short, Texans cannot simply keep $30,000.00 worth of anything they want. Instead, they must pick items off an approved list of items which, according to the legislature, are the sort of things sufficiently important for a Texas debtor to keep regardless of the claims of creditors. Once debtors have "gone shopping" from this approved list and picked out what they want to keep, however, they must "go to the checkout line," as it were, to see how much can actually be "purchased" out of the "budget" allowed by the Texas Legislature in section 42.001(a) of the Property Code. This second step in the process balances out the competing concerns of assuring a debtor a fresh start and assuring creditors a fair recovery on their legitimate claims. Letting the debtor have everything off the approved list without limitation offends the sensibilities of the common man (and woman) whom the legislature represents. . . .

The appropriate valuation standard is thus "fair market value," incorporating as it does an exposure of the item to the appropriate market for a reasonable period of time. In this case, the court adopts the fair market valuation suggested by First City's expert and finds the value of the 6.18 carat diamond ring to be $36,000.00.

The debtors are directed to file a new schedule B-4 listing their exemption claims in light of this decision. . . .

Although this decision gives the debtors a broad license to exempt property, the lower courts have seen to it that debtors who try to be too clever are apt to be sorry, as in one Virginia case in which the debtor claimed two partnerships exempt at a valuation of $1.00. The trustee did not object, but simply found a purchaser more than happy to purchase the partnerships for their market value, which was obviously far greater. In re GrUBLowsky, 149 B.R. 402 (Bankr. E.D. Va. 1993). The court held that the trustee may have been barred from objecting to the exemption, but only to the extent of the value claimed. The stay was lifted to permit the sale, with a full dollar to go to the debtor for each partnership interest. (Trustee: "Would you prefer cash or a check?")

5. Proceeds and Tracing

Exemptions are typically by category of property—wages, tools of the trade, motor vehicles, household furniture, alimony, etc.—but property is not static in nature. Wages may be deposited in checking accounts, property may be sold, contract obligations may be satisfied. Whenever the form of property changes, it raises issues about proceeds—that is, issues that focus on the application of an exemption to property that would not meet the classification requirements except that it constitutes proceeds from exempt property. The following cases illustrate the difficult and sometimes inconsistent resolutions of proceeds questions.
When Frank and Sondra Palidora ("Debtors") filed their chapter 7 petition they had $2,194.80 in their bank accounts. The Chapter 7 Trustee ("Trustee") moved for turnover of these funds less the $300 exemption provided by Arizona law for funds in a joint debtors' bank account. Debtors objected to the Trustee's motion by asserting that all of the monies in the bank account had derived either from Frank's wages or from a $1,000 check for child support that was paid to Sondra and deposited into her account.

Arizona's Wage Exemption Does Not Apply to Paid Wages

Arizona law exempts 75% of a debtor's disposable earnings. "Disposable earnings" are defined by A.R.S. §33-1131(A) to be "that remaining portion of a debtor's wages, salary or compensation for his personal services, including bonuses and commissions," after deducting state and federal withholdings.

The question, therefore, is whether "wages, salary or compensation for personal services" means only what is payable, or includes what has been paid, either by cash, check or direct deposit to a debtor's bank account. The meaning of a state exemption is controlled by the applicable state law, and a bankruptcy court is bound by the state's construction of a state statute. Applying the laws of other states, some bankruptcy courts have concluded that exempt wages retain their exempt status once paid and deposited in a debtor's bank account.

The Arizona Court of Appeals, however, has held that "the earnings protection of [A.R.S.] §§ 33-1131 and 12-1598.10 does not extend to monies disbursed to the debtor's bank account." Frazer, Ryan, Goldberg Keyt & Lawless v. Smith, 184 Ariz. 181, 186, 907 P.2d 1384, 1389 (App. Div. 1 1995). It did so for a number of cogent reasons. Most importantly, it relied on the statute governing garnishment procedures, n6 which expressly provides that "Earnings become monies, as defined in §12-1570, paragraph 6, upon their disbursement by the employer to or for the account of the employee, except disbursements into a pension or retirement fund." A.R.S. §12-1598.01(A). This necessarily means that "earnings" are only earnings until they are paid, and thereafter they are no longer earnings but are "monies." Although that definition is found in a different title of the Arizona statutes than the exemption provisions, the Court of Appeals concluded the statutes are "closely intertwined" and "must be given a consistent interpretation." Smith, 184 Ariz. at 185, 907 P.2d at 1387-88. Indeed, a later provision of the garnishment procedure statute relating to the continuing garnishment lien on earnings

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2. Arizona Revised Statutes ("A.R.S.") § 33-1133(B) opts out of the federal exemptions provided in 11 U.S.C. §522(d). A.R.S. §33-1126(A)(8) provides an exemption for a "total of one hundred fifty dollars held in a single account in any one financial institution ...." A.R.S. §33-1121.01 provides that in the case of married persons, each spouse is entitled to the personal property exemptions, effectively doubling the personal property exemptions in joint cases.
expressly cross references the exemption provision. A.R.S. §12-1598.10(F). The *Smith* opinion also noted that Arizona has other exemptions for monies in A.R.S. § 33-1126, but nowhere do the statutes "suggest that exempt monies include those that were formerly exempt earnings." *Id.* Finally, the Court of Appeals noted that Arizona's statute partially exempting disposable earnings was modeled after the federal Consumer Credit Protection Act, 15 U.S.C. §§ 1672-73, and that courts construing the federal garnishment exemption uniformly hold that it does not extend to earnings disbursed to a debtor's bank account. *Id.*, citing, e.g., *Usery v. First Nat'l Bank*, 586 F.2d 107, 110(9th Cir. 1978).

Because an Arizona court's construction of the Arizona exemption laws is binding on this Court, we must conclude that the Arizona wage exemption ceases to apply upon the debtor's receipt of those wages, whether paid in cash, by check, or by direct deposit in the debtor's bank account. In short, the wage exemption statute only limits what a creditor could obtain by garnishment of the employer, not what could be attached in the hands of the debtor.

**Child Support Payments are Trust Funds**

But for different reasons, paid child support is different from paid wages. In a case under the Bankruptcy Act, the Ninth Circuit held that where state law provides that child support payments are held by the custodial parent in a fiduciary capacity, such funds do not become property of the estate. *Boston v. Gardner (In re Gardner)*, 365 F.2d 242 (9th Cir. 1966) (applying Oregon law). In that case, the debtor's ex-husband had fallen behind in making child support payments. When he made the payments postpetition, the trustee sought to claim them on behalf of the estate because the debtor had a right to reimburse herself from those funds for the expenses she incurred in supporting the child while the payments were not being made. The Ninth Circuit held that the funds at issue "have their origin as trust assets for the child's support" and that because of that "origin and the mother's own support obligation, in our judgment her right of reimbursement cannot prevail over the child's claims." *Id.* at 243. Consequently the Ninth Circuit concluded the trustee had no claim to such funds unless it could clearly be shown that they were not necessary to satisfy the debtor's obligations to the minor child, "either present or during the future period of his minority." *Id.*

Because Bankruptcy Code §541(d) defines property held in trust not to constitute property of the estate, the holding of *Boston v. Gardner* should still be good law under the

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3. Although the *Smith* opinion did not note it, these provisions also distinguish "monies received by or payable to" a debtor from money "to be paid" a debtor. For example, A.R.S. §33-1126(A)(3) exempts "All monies received by or payable to a person entitled to receive child support or spousal maintenance pursuant to a court order," whereas A.R.S. §33-1126(A)(4) exempts only "money, proceeds or benefits of any kind to be paid" under an employer's health, accident or disability insurance. And there is a distinct $150 exemption for money held in a single bank account. A.R.S. §33-1126(A)(8). These distinctions also indicate that the Arizona legislature did not regard "earnings" as any form of money but rather as the compensation to be paid. They also suggest that the legislature did not intend the exemptions to continue to apply when the asset changes character unless the statutory language expressly so provided. Such an express provision was made for the homestead exemption, A.R.S. § 33-1101(C), which continues to apply for eighteen months to the "identifiable cash proceeds" from the sale of a homestead.
Code, at least with respect to states that define child support payments to be trust funds or funds held in a fiduciary capacity.

Although there does not appear to be an Arizona statute or judicial decision expressly declaring child support payments to be trust funds, they do imply as much. "Every person has the duty to provide all reasonable support for that person's natural and adopted minor, unemancipated children, regardless of the presence or residence of the child in this state." A.R.S. §25-501(A). "The obligation to pay child support is primary and other financial obligations are secondary." A.R.S. § 25-501(C). "All duties of support as prescribed in this chapter may be enforced by all civil and criminal remedies provided by law." A.R.S. § 25-501(D). Little v. Little, 193 Ariz. 518, 522, 975 P.2d 108, 112 (1999) (Arizona law prescribes that "the obligation to pay child support is primary and other financial obligations are secondary."); Jorgensen v. Jorgensen, 131 Ariz. 271, 273, 640 P.2d 202, 204 (App. Div. 2 1981) ("A parent obligated to pay child support may not avoid that obligation by voluntarily incurring debts that reduce the ability to pay, since the ability to pay such support must be determined by viewing the child support obligation as a primary obligation superior to all other financial obligations." (Citations omitted)); Beck v. Jaeger, 124 Ariz. 316, 317, 604 P.2d 18, 19 (App. Div. 2 1979)("Other financial obligations are secondary . . ."). Arizona courts have held that former spouses may not "bargain away custody and child support provisions of a divorce decree in exchange for interests in real property which serve only to enhance the financial interests of the parties themselves and completely disregard the welfare of the children." Evans v. Evans, 17 Ariz. App. 323, 325-26, 497 P.2d 830, 832-33 (Div. 2 1972). "A parent may not form a valid and enforceable contract which releases the parent from all obligation to support his or her minor children." Smith v. Saxon, 186 Ariz. 70, 73, 918 P.2d 1088, 1091 (App. Div. 1 1996).

From these authorities this Court concludes that an Arizona court would find that money paid by a former spouse to a custodial parent for child support pursuant to a court order are trust funds held by the custodial parent for the benefit of the child. Under Bankruptcy Code §541 and Boston v. Gardner, such funds are not property of the estate.

Moreover, even if the funds paid as child support are not trust funds, they are exempt under Arizona law. A.R.S. §33-1126(A)(3) exempts "All monies received by or payable to a person entitled to receive child support or spousal maintenance pursuant to a court order." Unlike the wage exemption statute, this exemption provision expressly includes not only such money payable to a debtor, but also such money received by a debtor. Consequently the exemption would continue in the funds when deposited in a bank account, provided they are traceable to the exempt source.

There is an important proviso to these conclusions, however. The exemption statute makes clear that the child support payments must have been made pursuant to a court order. And the trust fund analysis does not apply to parents who are still married to each other. "A.R.S. §12-2451 [currently 25-501] imposes a general duty on parents to support their children, but there is no duty on one parent to pay a certain sum to the other parent for child support." Lamb v. Superior Court, 127 Ariz. 400, 402, 621 P.2d 906, 908 n.l (1980). On this record, it is not possible to determine whether the alleged $1000 check to Sondra for child support was paid by the debtor husband Frank or was paid by a former husband pursuant to a valid court order for child support. The former would be nonexempt property of the estate, while the latter would be both exempt and not property of the estate.
CONCLUSION

For the foregoing reasons, the Trustee's objection to the Debtors' claim of exemption of the bank account based on the wage exemption is sustained. The Court is not in a position to rule on the claim of exemption for child support payments pending further factual development.

In a feat of financial planning that may give some clue as to why he ended up in bankruptcy, Kenneth Dasher cashed out every last nickel in his retirement account to buy a pick up truck. In re Dasher, 2002 U.S. Dist. Lexis 10563 (Neb. 2002). His retirement account was fully exempt and he made the purchase after he had filed for bankruptcy (surely not on advice of counsel). He amended his schedules to claim his new pick up as exempt, pointing out that it was just his retirement account in a little more tangible form. The court said no, and in a deeply insightful opinion, pointed out some of the key differences between a “retirement account” and a “pick up truck.” The trustee seized the pick up and sold it, all for the benefit of the creditors. Note that if Mr. D had just waited to cash in his retirement account after his bankruptcy case was closed, he would have discharged his debts and owned the pick up outright. But sometimes a man can’t wait.

6. Partially Exempt Property

One exemption issue is often confusing: If there is a dollar limit on an exempt category, does property of a greater value cease to be exempt? The answer is that such property is partially exempt. In most cases the property can be levied on and sold. If that happens, the exemption attaches, up to its dollar limit, to the cash from the sale. Following a judicial sale of exempt property, the proceeds are allocated first to the debtor to the full amount of the exemption. The remainder goes to the judgment creditors.

An example will illustrate: If a state recognized an exemption of $1,000 for a car for each individual, a debtor who owned a car worth $800 would be able to protect the car from any creditor attachment. A debtor who owned a car worth $2,800 subject to no consensual liens would be subject to having the car seized and sold for the benefit of a judgment creditor. If the creditor was owed $3,000 and the car brought $2,800 at a judicial sale, the proceeds would be divided between the debtor ($1,000 in satisfaction of the exemption) and the judgment creditor ($1,800 as non-exempt value).

7. Security Interests in Exempt Property

The debtor's exemption is relatively easy to determine when only the TIB (acting on behalf of all the unsecured creditors) claims an interest in potentially exempt property. If, for example, a debtor owns a car valued at $1,000 that is eligible for a federal
exemption of $1,200, the debtor keeps the car. If the car were worth $5,000, the TIB would sell the car, the debtor would keep the first $1,200, and the TIB would take the remainder for distribution to the creditors.

When potentially exempt property is encumbered by a security interest valid in bankruptcy, the secured party moves ahead of both the debtor and the TIB. If the car mentioned above were worth $1,000 and the secured creditor's claim were for $2,000, the secured party would take the car. (Computation of the secured creditor's allowed claim in bankruptcy is covered in the next section.) The debtor would have no exemption and the TIB would have nothing for distribution. If the car were worth $3,000, the car would be sold, the secured party would take $2,000 (the full amount of the allowed secured claim), and the debtor would keep the remaining $1,000. Only when the value of the car exceeds the sum of the allowed secured claim and the debtor's exemption would the TIB be able to reach any value from the property.

8. Avoiding Judicial Liens and Non-PMSI Liens

In addition to personal exemptions, Congress fashioned another protection to improve the economic position of post-bankruptcy debtors. Section 522(f) permits the avoidance of certain kinds of liens on certain categories of exempt property listed therein. Two kinds of liens are made avoidable: judicial liens (that is, liens that are imposed by a court after a judgment has been rendered and a defendant has not paid) and nonpossessory, nonpurchase money consensual security interests (when, for example, a creditor lends money and takes a security interest in the household goods the debtor already owns). In order to void the liens, the collateral must be exempt property. In addition, to void a consensual security interests, the property must also be of a kind of “household good” that is specified in 522(f)(4). The effect of these provisions is that creditors who hold these judicial liens or security interests can be treated like any other general unsecured creditor, entitled only to a pro rata share of the debtor's entire estate—not a special claim to some of the debtor's property. In effect, the law here says that these creditors cannot push their claims ahead of the debtor's exemption, as creditors with regular security interests or liens can.

In general, a debtor may avoid all judicial liens on exempt property, regardless of the nature of the debt secured by the lien. One important exception, however, is that a judicial lien that secures a debt for a domestic support obligation is exempt. §522(f)(1)(B). Those judicial liens remain intact no matter what.

Section 522(f)(1)(B), which voids certain voluntary security interests, was adopted largely in response to a growing concern about the use of security interests by certain finance companies to prey on the poor. Several studies documented established practices of taking security interests in all of a debtor's clothing, in children's toys, in household linens, in family photographs. Many critics pointed out that these security interests were not taken to provide alternate resources to satisfy the loan if the debtor should become unable to pay. Instead, the security interests were taken for their "hostage value," for the likelihood that threatened repossession would cause the debtor to make any sacrifice to find a way to pay. Section 522(f) was adopted in the 1978 Code to defeat these practices in the context of bankrupt debtors.

When section 522(f) was added to the Bankruptcy Code back in 1978, the FTC soon followed suit by imposing similar restraints on creditors outside bankruptcy. The rule was adopted in part to respond to the charges of abuse and in part to limit any special
incentive to file bankruptcy. The FTC rule makes it an unfair practice for a company to take a nonpossessory, nonpurchase money security interest in certain listed goods. FTC Trade Regulation Rule on Credit Practices, 16 C.F.R. §444.1 (1985). The 2005 Amendments to the Bankruptcy Code bring the enumerated lists of protected goods into closer alignment.

The FTC was careful to make these rules apply only to security interests created after the effective date of the rules, thereby avoiding a controversy that arose in the application of section 522(f). In United States v. Security Industrial Bank, 459 U.S. 70 (1982), the Court was faced with a constitutional attack on section 522(f) by secured creditors holding the kind of nonpossessory, nonpurchase money liens that the section permits the debtor to void. The secured creditors did not try to claim that Congress could not ban, or make voidable, such liens, but contended that an application of the section 522(f) voiding power to a preexisting lien, i.e., one obtained prior to passage of the Code, would be an unconstitutional deprivation of property under the Fifth Amendment. The United States intervened in the case to defend the constitutionality of the statute.

The six-member majority opinion managed to avoid a square ruling on the constitutional issue. The majority strongly intimated that a retroactive application of the section 522(f) voiding power might violate the Fifth Amendment property rights of secured creditors, but stopped short of so holding. Instead, the majority held that the serious constitutional question involved required a strict reading of the statute so as to avoid the constitutional issue if possible. On such a reading, the majority concluded that Congress did not intend to apply section 522(f) to preexisting liens and therefore the constitutional issue did not have to be addressed.

Three justices concurred in the judgment on the basis of a 1902 precedent holding that the bankruptcy statutes should not be construed as affecting preexisting rights unless Congress clearly so intended. The concurring justices would have held section 522(f) to be constitutional had they reached that issue.

Security Bank raised, but did not resolve, fascinating and recurring problems concerning the extent of Congress's power under the bankruptcy clause of the Constitution to disappoint the expectations of the marketplace. For example, it is said that Congress has considerable power to displace otherwise enforceable "contract rights," but not to deprive persons of "property" under the Fifth Amendment. That can be a very tenuous distinction to maintain. In many contexts, such as enforcement of security agreements in accounts receivable under Article 9 of the UCC, "contract rights" are treated as property. See generally Michelman, Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law, 80 Harv. L. Rev. 1165 (1967).

Even if it were clear which rights are "property" protected by the Fifth Amendment and which are not, there would remain the question of the limit on Congress's power to restrict those rights short of that "deprivation" requiring compensation. Michelman, supra.

It seems clear that Congress can redefine property prospectively. It can say that henceforth those who acquire certain property interests will not enjoy certain rights that existing holders of such interests now enjoy. It is also clear that Congress can limit existing property rights to some considerable degree in the name of regulation or taxation without the limitation being a "deprivation." Such limitations in the bankruptcy context can include a temporary withdrawal of certain property rights, as with the prevention of foreclosure or repossession by the operation of the automatic stay. On the other hand, it seems equally clear that at some point a bankruptcy rule could so undermine existing
property rights that the Fifth Amendment's protection would come into play. The issue has arisen many times in bankruptcy and will no doubt arise again.

Problem Set 8

8.1. Harv and Lois Hughes live in an apartment in Houston, Texas. They are unable to pay several of their debts and are worried about which of their assets may be vulnerable to creditor attachment. Their largest creditor is the IRS, to whom they owe about $5,000 in back taxes. They list their assets as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household furniture and appliances</td>
<td>$8,000</td>
</tr>
<tr>
<td>Clothing</td>
<td>2,000</td>
</tr>
<tr>
<td>Lois's law books</td>
<td>2,400</td>
</tr>
<tr>
<td>Lois's Moped</td>
<td>800</td>
</tr>
<tr>
<td>Harv's 1970 MGA (left over from high school, now up on blocks)</td>
<td>500</td>
</tr>
<tr>
<td>Cash value on Lois’s insurance</td>
<td>2,000</td>
</tr>
<tr>
<td>Lois’s wedding ring</td>
<td>1,000</td>
</tr>
<tr>
<td>Lois’s computer</td>
<td>1,200</td>
</tr>
<tr>
<td>100 shares Disney Co. (Lois’s Dad knew Walt)</td>
<td>5,000</td>
</tr>
<tr>
<td>Joint checking account</td>
<td>200</td>
</tr>
<tr>
<td>Harv’s computer set up</td>
<td>7,500</td>
</tr>
<tr>
<td>Joint checking account</td>
<td>200</td>
</tr>
<tr>
<td>15 year old, 25-foot Friendship Sloop (with rebuilt depth finder)</td>
<td>6,000</td>
</tr>
<tr>
<td>Harv’s motorized wheelchair</td>
<td>18,000</td>
</tr>
<tr>
<td>Fluffy (Persian cat, nasty temper but very beautiful)</td>
<td>200</td>
</tr>
<tr>
<td>Soccer ball</td>
<td>2</td>
</tr>
</tbody>
</table>

Harv, who is a computer programmer, was injured last year when his car was struck by a train. He has been rated at a 40 percent disability as a result. His lawyer says he can likely settle with the railroad for about $50,000 (there were some serious contributory negligence issues). What can Harv and Lois protect as the creditors begin to move in? What could they protect if they lived in Wilmington, Delaware?

8.2. Harv's cousin Suzan Hughes is also in financial trouble, but Suzan has always been a bit more aggressive than Harv. She works as a computer programmer, but she decided her fortune would ride on her ability to spot valuable rare books. She sold nearly everything she had to acquire a stunning old book and manuscript collection. The collection now includes a fine thirteenth century illuminated-text Bible. The Bible is worth about $500,000 and the remainder of the library is worth another $600,000. Her other assets are worth about $50. Suzan's creditors are closing in. What can she keep if she lives in Odessa, Texas? What can she keep if she lives in Dover, Delaware?

8.3. Kim Sung owns a home in a state that permits an individual debtor to exempt $25,000 in value of the debtor's homestead from creditor attachment. Kim bought the
house in 1990. He paid $5,000 down and signed a mortgage obligation for $45,000, which he has paid down to $40,000. Similar houses are now selling for about $75,000 when they are put on the retail market for two or three months and listed with a real estate broker, who charges a 6 percent commission. A similar house sold in a sheriff's auction last month for $29,428. (It was bought by the creditor for whom the sale was being held for exactly the amount of the debt owed the creditor. The creditor was the only one who showed up at the sale.)

Kim owes a judgment creditor $25,000. Assuming the court is not bound by any precedential decisions, what are the court's options in determining whether to order a judicial sale? Explain the rationale for each option and pick the best. Be sure to note how the proceeds of any sale will be distributed. Should the decision on forcing a sale differ if the judgment creditor is a victim of an accident in which Kim was driving drunk or if the creditor is the legal alter-ego of an aluminum siding company that swindled Kim so cleverly that he'll never be able to prove it? Should it matter if it is the mortgagee rather than a judgment creditor that is attempting to have the property sold in satisfaction of the debt? See §522(a)(2).

8.4. Charley Wilson has worked for 12 years on construction sites, most recently as a crane operator. Charley has purchased and completely paid for a 1994 three-quarter-ton Dodge pick-up. When the local construction industry entered yet another slump, Charley used the pick-up as collateral for a $6,500 loan from his credit union. After three months with no work, Charley decided to go into business for himself, and he began work as "Charley's Trash Hauling and Light Deliveries." His new business has not been very successful, and Charley filed for bankruptcy two months after opening, although he was still trying to make the business go. The credit union has filed to lift the stay on the pick-up so that it can repossess and sell it. Assuming the federal exemptions apply, should the stay be lifted? See §522(f). Would it matter if Charley were doing light hauling and working on the crane part-time? If Charley were just driving the pick-up back and forth to the construction sites? If he drives it to collect unemployment checks? Is there any way his creditor can tell how he uses it? Does that matter? What result for Charley if his state's law (a) opts out of the federal exemptions; (b) makes tools of the trade exempt up to $1,000; (c) makes motor vehicles exempt up to $2,000; and (d) says that all consensual liens on exempt property are fully enforceable? See §522(f)(3).

D. HOMESTEADS, TRUSTS, AND EXEMPTION PLANNING

You have learned the basics about exemptions as they affect most debtors. Because the great majority of debtors have few assets of any value, apart from a heavily mortgaged home, exemptions are important to them only at the “barrel” level—that is, enough protection to cover their clothes, basic household goods, vehicles necessary to daily transportation, and the like. For just that reason, attempts to show that exemption levels are fundamental to bankruptcy policy (or credit availability) have failed. Exemptions beyond a very basic floor don’t matter to most middle-class debtors. (See infra pp. 103-04).
On the other hand, exemptions matter a good deal to the small minority of more affluent debtors most likely to need more sophisticated legal advice. Exemptions also serve as a check on affluent debtors who might exploit too liberal a system, as demonstrated by the debates about unlimited homestead exemptions. Part of that debate includes public perceptions of the bankruptcy system that may be soured by well-publicized instances of debtors escaping their legal obligations by manipulating luxury property to keep it from the legitimate claims of their creditors, including fraud victims. Thus the higher levels of exemption policy matter, even though they do not much affect most debtors.

This section addresses the exemption issues surrounding that minority of debtors who have assets of substantial value. The section is not limited to exemption rules, because there are two ways that more affluent debtors protect assets from their creditors: some take advantage of large exemptions and others count on excluding certain assets from their estates. Property may be excluded by operation of law (e.g., most retirement funds are excluded from the estate in section 541). Other property may be excluded by use of trusts that show that the debtor has no remaining legal interest in property the debtor nonetheless seems to control and enjoy. Either device—exemptions or exclusion—puts the debtor’s assets beyond the reach of unpaid creditors.

The struggle over what property debtors may and may not keep when they are unable to pay all their creditors as promised has deep social and economic implications. The stakes in these questions can be quite high. Nowhere do they come into greater collision than in the protection afforded homeowners.

1. Homestead Exemptions

The most important type of exempt property for many debtors is the homestead, which is typically the real property occupied by the debtor as a residence. Financially, homes are the most significant assets owned by most Americans. More than 60 percent of all wealth held by individuals is in the form of homes. Homeownership is a cumulative phenomenon, with about 68 percent of the total population owning their own homes, and an astonishing 90+ percent of all Americans over the age of 50 owning the homes they live in. For many, a home represents not only their accumulated wealth, but also their hold on a middle-class lifestyle.

The homestead exemption as we know it developed largely in the nineteenth century. In his very interesting article, Protection of the Family Home from Seizure by Creditors: The Sources and Evolution of a Legal Principle, 86 S.W. Hist. L.Q. 364, 369 (1983), Professor Joseph McKnight examined the sources of the modern homestead exemption laws. He found:

In popular as well as legal parlance, homestead means not only family home but property that is accorded particular protection because it is the family home. From one American state to another, and elsewhere as well, the most significant protection of the home is that which is accorded it against seizure by the owner's creditors for payment of general, private debts. The term homestead was also once used to refer to a sovereign grant of western lands where the frontiersman and his family made their home. But it is in the sense of a home protected from creditors that the concept of homestead is one of the most significant later contributions to family jurisprudence.
Legal tradition has long acknowledged that this notion of homestead emerged on the Mexican-Texan frontier. But the sources and development of the concept have never been clearly demonstrated. Simply stated, the tradition is that an 1829 act of the Mexican state of Coahuila y Texas recodified Castilian exemption principles and extended them to sovereign grants of land. Carrying this development forward, a Texas act of 1839 defined exempt lands in terms of the family home, and from this model the principle of homestead exemption from the claims of creditors spread throughout the United States and beyond.

Professor McKnight bases his analysis on dual themes: the Anglo-American and Hispanic legal traditions of the time, and the continuing political concerns of the independent government of Coahuila y Texas to attract settlers and to protect resident debtors. Professor McKnight explained one interaction between debtor-creditor laws and migration during the nineteenth century.

Moving West was a frequent early nineteenth-century response to the series of economic crises in the new American nation. A move to Texas where land was cheap was particularly attractive to venturous spirits in the southern United States. The Texas colonists were by no means generally insolvent, but there were some who came to Texas with the hope of leaving debts permanently behind them, and those debts were sometimes large. By the mid-1820s Texas had achieved the reputation as a haven for debtors. First in 1826 and again in 1828 the United States Congress directed questions to the president concerning the obvious irritant to American creditors whose debtors had removed themselves to Mexican territory. The perception of Texas as a refuge for debtors was a consequence of several factors: Texas's primitive judicial system, the difficulty of finding debtors there, and, most particularly, the reluctance of local judges to enforce foreign debts against fellow colonists.

The American financial crisis of 1837, which precipitated the movement of so many distressed debtors into Texas, was a likely catalyst to the 1839 Texas enactment.

By 1829, generous homestead and family property exemptions were firmly established in Texas law. The homestead exemption, born of a blending of two legal cultures, soon took root in several states. Professor McKnight traces the spread of the homestead exemption beyond Texas:

The Hispanic and Anglo-American traditions of exempt property thus interacted to produce the lasting concept of protecting the family home and certain movables from the claims of creditors. These ideas came to full flower in the formulation of the homestead and chattel-exemption provision of the Texas Constitution of 1845. Forceful minds, well versed in the Hispanic concepts of exempt property and their further development in the decree of 1829, composed and passed the constitutional provision that would publish the expanded concept of exempt property in louder tones to the rest of the United States. The idea had already spread, on the apparent inspiration of the 1839 act, to Mississippi, Georgia, and Florida; within a few years more, similar provisions were enacted in a number of other states and were added to some state constitutions. Well before the end of the century the family home had been extended protection from creditors in almost every American state.

Homestead exemptions are now available in a large number of jurisdictions. Even so, not every homeowner is protected. Twenty states protect less than $20,000 equity in a
homestead, and four more states (including Delaware) offer no homestead protection of any kind. In addition, a number of states have a doctrine known as "tenancy by the entirety" that has some effect in protecting a homestead. By application of this principle of property law, the courts prohibit a creditor of only one spouse from foreclosing on a homestead held by the entirety — that is, jointly owned by the married couple. See, e.g., Patterson v. Hopkins, 247 Pa. Super. 163, 371 A.2d 1378 (1977). This effectively stops a general unsecured creditor from forcing a sale of a home to satisfy a debt if the creditor is owed an obligation by only one spouse, regardless of the value of the home. It does not, of course, have any restraining effect if the creditor has extended credit to both husband and wife or if the debtor is a single person.

Typically, the homestead is exempt from execution by creditors up to a given dollar amount. But seven states and the District of Columbia now offer homestead protection based on area or some other test. As we noted in the preceding section, for example, Texas law exempts a homestead that covers up to 10 acres in a city and 200 acres in the country. Arkansas protects homesteads up to a quarter-acre in a city and 80 acres in the country. At the legislative level policy debates continue over how generous the exemptions should be and what class of debtor should be favored by them. The debate is particularly loud in Florida, where a homestead of unlimited value can be protected, a circumstance that is said to have attracted former baseball commissioner Bowie Kuhn, former ambassador Marvin Warner, and convicted inside-trader Martin A. Siegel, all of whom were able to protect multi-million-dollar homes from their very angry creditors. The other states with unlimited homestead exemptions evidently have not been so attractive to those fleeing their creditors, so the debates elsewhere have not been so lively.

2. Exemption Planning

Because Texas and states like it protect unlimited value in a homestead, the debtor has the opportunity to do some careful planning before filing for bankruptcy to discharge his debts. Mr. Reed seems to be one of these careful planners.

In re REED

Brister, Bankruptcy Judge.

The debtors filed petition for order for relief under Chapter 7 of Title 11, United States Code, on December 21, 1979. During the two week period preceding the filing of the petition the debtors, obviously engaging in prebankruptcy planning, sold nonexempt personal property for approximately 50% of the value which they had assigned to those properties and applied the proceeds of $34,500.00 towards liquidation of liens against their residence homestead. The trustee filed a complaint challenging entitlement to the exemptions. The following summary constitutes the findings of fact contemplated by Rule 752 after nonjury trial.

Since his childhood Hugh D. Reed had collected approximately 35 guns, some of them commemorative guns or otherwise having collector's value. On a financial statement dated April 1, 1979, he had valued the gun collection at $20,000.00. On
December 11, 1979, ten days prior to filing the petition in bankruptcy, he sold the entire
gun collection to a friend, Steve Gallagher, for $5,000.00 cash.

Reed had been an antique collector, also. On the April 1, 1979, financial statement
he had valued his antiques at $3,000.00. Three months later, in August, 1979, he
purchased additional antiques from an estate for $11,000.00. In late November, 1979, he
sold three items from the antique collection to an acquaintance, Charles Tharpe, for
$3,500.00, applying the proceeds to payment of a note to Bank of the West. On
December 11, 1979, he sold the remaining antiques to the friend, Steve Gallagher, for
$5,000.00 cash.

In November 1979, approximately one month prior to the commencement of the
bankruptcy proceedings, he purchased for $15,000.00 an interest in a corporation with the
intriguing name of Triple BS Corporation. He sold that interest to the friend, Steve
Gallagher, on December 11, 1979, for $5,000.00 cash.

In three separate transactions between October 5, 1979, and November 13, 1979,
Reed had purchased gold coins—Krugerrands and Mexican Pesos—for the total sum of
$22,115.00. On or about December 10, 1979, he sold those coins for $19,500.00 cash.

Thus, ten days prior to bankruptcy debtors sold nonexempt assets with aggregate
value of $68,500.00 (according to their financial statements or based upon the amount
actually paid by them on recent purchases), receiving as proceeds the sum of $34,500.00.
They received market value for the gold and when that transaction is not considered they
received less than 20% of the apparent value of the guns, the antiques and the interest in
Triple BS Corporation.

In October 1978, the debtors had executed a note and mechanic's lien to a lending
institution in the sum of $20,000.00 to pay for improvements to their residence,
consisting of a sun-deck room, swimming pool and pool facilities. On December 11,
1979, $19,892.00 from the proceeds of sale of nonexempt assets were applied to pay off
that improvement loan. The balance of $15,000.00 was applied by the debtors towards
the vendor's lien note against the residence, reducing the balance of that note to
approximately $28,000.00.

The scope of this memorandum is narrow. The trustee insists that the homestead
exemption on the residence should be avoided, because of the flagrant prebankruptcy
planning in which they engaged. As evidence of fraudulent intent, the trustee contends
that the debtors received less than a reasonably equivalent value for the nonexempt
assets. Mr. Reed very candidly testified that had he received more money for the
nonexempt assets he would have applied those additional monies to the homestead liens.

The debate as to whether the homestead exemptions may be set aside under those
facts is clearly drawn.

The debtor, in support of his contention that he could properly pay the liens with
proceeds of nonexempt property, and thus engage in obvious exemption planning, cites a
comment in the legislative history following §522(b):

As under current law, the debtor will be permitted to convert nonexempt property
into exempt property before filing a bankruptcy petition. See Hearings, pt. 3, at 1355-
58. The practice is not fraudulent as to creditors, and permits the debtor to make full
use of the exemptions to which he is entitled under the law.

While that language may express the law in some jurisdictions, it is not universally
true. Certainly it is not an accurate expression of Texas law because Texas law
specifically prohibits the retention of an exemption in personal property so acquired
with proceeds of nonexempt property where there was intent to defraud, delay or hinder a creditor or other interested persons.

In this case, however, there was no proof that the debtors had applied the proceeds to acquisition of exempt personal property. All of the evidence indicates that the entire proceeds of $34,500.00 were applied on the real estate liens. The Texas legislature, at the time it adopted V.A.T.S. Article 3836(b), [predecessor to §42.004 supra] had the opportunity to include the same language in V.A.T.S. Article 3833, [predecessor to §41.002, supra p. 61] which provides the homestead exemption in real estate. It failed to do so, and had it included that type of language it is doubtful that it would have passed constitutional muster. Historically Texas law has jealously protected the homestead from forced sale except under very limited conditions. Article 16, §50 of the Texas Constitution prohibits forced sale for any purpose except for purchase money liens, improvement liens, or taxes.

That provision in the Texas constitution prohibits the granting of the relief sought by the trustee in this case and the challenge to the homestead exemption in the residence is denied.

But Mr. Reed was not home free. Remember, he is in bankruptcy in order to discharge his outstanding debts. When the trustee appealed the bankruptcy court decision, the Fifth Circuit took a hard look at Mr. Reed and the Triple BS Corporation and did not like what they saw.

In re REED
700 F.2d 986 (5th Cir. 1983)

Rubin, Circuit Judge.

We hold that a debtor who converts nonexempt assets to an exempt homestead immediately before bankruptcy, with intent to defraud his creditors, must be denied a discharge in bankruptcy because of the provisions of Section 727 of the Bankruptcy Code, 11 U.S.C.A. §727 (West 1979), and, therefore, we affirm the decision of the district court.

I

Hugh D. Reed, as sole proprietor, opened a shop using the trade name, Reed's Men's Wear, in Lubbock, Texas. He financed the venture in part by obtaining from the Texas Bank & Trust Company a $150,000 loan which was guaranteed by the Small Business Administration (SBA). Three months later, the bank gave Reed a $50,000 line of credit, and the SBA agreed that the original loan would be subordinated to the line of credit. The store showed a profit for the first nine months of operation in 1977, but began to lose money in 1978.

By February 1979, Reed knew that his business was insolvent. After meeting with the bank, the SBA, and his major trade creditors, he signed an agreement to turn over management of the store to a consulting firm for the year 1979. In turn, Reed's trade creditors agreed to postpone collection efforts and Reed promised to resume payments
in January 1980. Despite management by the consultant, the business continued to fail, and on December 15, 1979, Reed and his wife, Sharon Marcus Reed, signed a foreclosure agreement surrendering the store to the bank. Six days later, the Reeds filed voluntary petitions for bankruptcy.

* * *

Reed had catholic interests and much energy. He found time to collect antiques, gold coins, and guns, and to make other investments. In a financial statement provided to the bank and to the SBA on April 1, 1979, Reed valued his gun collection at $20,000 and his antiques collection at $3,000. In the four months prior to bankruptcy, Reed augmented each of his collections. He caused Reyata [Corporation, which Reed owned] to borrow $11,000, which he used to purchase more antiques. In three separate transactions during October and November, Reed accumulated, at a cost of $22,115, a collection of Krugerrands and Mexican fifty-peso pieces. One month before filing for bankruptcy, Reed purchased, for $15,000, a one-third interest in a business known as Triple BS Corporation.1

Two months before bankruptcy, Reed opened an account at the Bank of the West without the knowledge of his creditors. From that time until the store closed in mid-December, he deposited the daily receipts from Reed's Men's Wear in this separate account. From this account, in late November Reed repaid the loan Reyata made to purchase the antiques.

Reed began selling his personal assets in late November. He first sold three items from his antiques collection to an acquaintance, Charles Tharpe, for $3,500. He sold the remainder of his antiques on December 11 to a friend, Steve Gallagher, for $5,000. Whether this represented their fair market value was not established, but the total realized on the antiques was $8,500, while the original value plus the cost of recent purchases was $14,000. On December 10, he sold his gold coins through a broker for $19,500 cash, their approximate market value. The next day, on December 11, Reed sold to Gallagher for $5,000 each both his gun collection and his Triple BS stock. Whether or not Gallagher paid fair market value for the items was not established, but the stock had been purchased only one month earlier for $15,000.

Reed applied all of the proceeds to reduce the mortgages on his family residence, which was exempt from creditor's claims under Texas law, with the objective, the bankruptcy court found, of reducing the value of his nonexempt assets and increasing the value of his homestead exemption prior to bankruptcy. Thus he raised about $35,000, applying about $30,000 [should read "$20,000" — eds.] to wipe out a second mortgage home improvement loan and applying the balance of approximately $15,000 to reduce the first mortgage on his home to about $28,000.

Reed cavalierly justified his sale of assets for what appeared to be less than their fair market value. This was of no concern to his creditors, he testified, because, if he had received more for the assets, he would have simply applied the additional sum to reduce the mortgage on his homestead. No matter how much he got, there would be nothing for his creditors.

Reed also failed to account for the disposition of $19,586.83 in cash during the year preceding filing. Reed attempted to explain the "unaccounted for" cash by testifying that he habitually carried huge sums of money in cash on his person and frequently made purchases and payments in cash without obtaining receipts. He argued

1. The significance of the initials is not elucidated in the record.
that the amount of "unaccounted for" cash represents only a small percentage of the amount of money which went through his hands in 1979.

The bankruptcy judge found that Reed had effected transfers designed to convert nonexempt property into exempt property less than two weeks before bankruptcy with the intent to hinder, delay, or defraud creditors. 11 U.S.C.A. §727(a)(2) (West 1979). He found that, regardless of the amount of money that might have passed through Reed's accounts, $19,586.83 is a significant sum, and that Reed had failed satisfactorily to explain its loss. This constituted an additional basis for denying discharge. 11 U.S.C.A. §727(a)(5) (West 1979).

The district court affirmed the judgment.

II

The Bankruptcy Code provides that a debtor may be denied discharge if he has transferred property "with intent to hinder, delay, or defraud a creditor," 11 U.S.C.A. §727(a)(2) (West 1979), or has "failed to explain satisfactorily . . . any loss of assets. . . ." 11 U.S.C.A. §727(a)(5) (West 1979). Reed was denied discharge on both bases. Though either would suffice, we review the grounds seriatim.

In considering the effect of Reed's transfers of assets, we distinguish, as did the careful opinion of the bankruptcy court, the debtor's entitlement to the exemption of property from the claims of his creditors and his right to a discharge from his debts. The Bankruptcy Code allows a debtor to retain property exempt either (1) under the provisions of the Bankruptcy Code, if not forbidden by state law, 11 U.S.C.A. §522(b) and (d) (West 1979), or (2) under the provisions of state law and federal law other than the minimum allowances in the Bankruptcy Code, 11 U.S.C.A. §522(b)(2) (West 1979).

Under the Bankruptcy Act of 1898, most courts, applying state exemption laws, had held property that would otherwise have been exempt to be deprived of its immunity if there was evidence other than the simple act of conversion showing that the debtor had acquired it with the intention of defrauding his creditors. If intent to defraud was not proved, however, and it was shown only that granting the exemption would defeat the creditor's claim, the exemption was granted. As stated in 3 Collier on Bankruptcy, ¶522.08[4] (15th ed. 1982): "Under the Act, the mere conversion of nonexempt property into exempt property on the eve of bankruptcy was not of itself such fraud as will [sic] deprive the bankrupt of his right to exemptions." (Emphasis supplied.)

Before the Bankruptcy Code was adopted in 1978, it had been urged that property obtained in such last-minute conversions be ineligible for exemption. Id. The Code, however, adopts the position that the conversion of nonexempt to exempt property, without more, will not deprive the debtor of the exemption to which he would otherwise be entitled. 3 Collier, supra, ¶522.08[4]. Thus, both the House and Senate Reports state:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

decision is summed up at 3 Collier, supra, ¶522.08[4]: "The result which would obtain if debtors were not allowed to convert property into allowable exempt property would be extremely harsh, especially in those jurisdictions where the exemption allowance is minimal." Nonetheless, the phrase, "[a]s under current law," qualifies the apparently blanket approval of conversion, since as noted above, courts denied exemptions under the Act if there was extrinsic evidence of actual intent to defraud (and if the state law permitted disallowance of the exemption for fraud).

Reed elected to claim his exemptions under state law. The bankruptcy judge, therefore, referred to Texas law to determine both what property was exempt and whether the exemption was defeated by the eleventh-hour conversion. Texas constitutional and statutory protection of the homestead is absolute, and the bankruptcy judge interpreted Texas law to allow the exemption in full regardless of Reed's intent.

While the Code requires that, when the debtor claims a state-created exemption, the scope of the claim is determined by state law, it sets separate standards for determining whether the debtor shall be denied a discharge. The debtor's entitlement to a discharge must, therefore, be determined by federal, not state, law. In this respect, 11 U.S.C. §727(a)(2) is absolute: the discharge shall be denied a debtor who has transferred property with intent to defraud his creditors. The legislative history of the exemption section, as noted above, does not mean that conversion is never fraudulent as to creditors, but simply that, as under prior law, mere conversion is not to be considered fraudulent unless other evidence proves actual intent to defraud creditors. While pre-bankruptcy conversion of nonexempt into exempt assets is frequently motivated by the intent to put those assets beyond the reach of creditors, which is, after all, the function of an exemption, evidence of actual intent to defraud creditors is required to support a finding sufficient to deny a discharge. For example, evidence that the debtor, on the eve of bankruptcy, borrowed money that was then converted into exempt assets would suffice to support a finding of actual intent to defraud. Only if such a finding is made may a discharge be denied.

The evidence amply supports the bankruptcy court's finding that Reed had an actual intent to defraud. Reed's whole pattern of conduct evinces that intent. Cf. Farmers Co-op. Assn. v. Strunk, 671 F.2d 391, 395 (10th Cir. 1982) ("Fraudulent intent of course may be established by circumstantial evidence, or by inferences drawn from a course of conduct"). His rapid conversion of nonexempt assets to extinguish one home mortgage and to reduce another four months before bankruptcy, after arranging with his creditors to be free of payment obligations until the following year, speaks for itself as a transfer of property in fraud of creditors. His diversion of the daily receipts of Reed's Men's Wear into an account unknown to his creditors and management consultant and his subsequent use of the receipts to repay a loan that had been a vehicle for this conversion confirm his fraudulent motivation. . . .

The fact findings of the bankruptcy judge, affirmed by the district court, are to be credited by us unless clearly erroneous. . . . [A]nd the finding of actual intent to defraud, based on evidence other than the fact of the conversion, patently was not permeated with error. The denial of a discharge on this ground alone was appropriate. It would constitute a perversion of the purposes of the Bankruptcy Code to permit a debtor earning $180,000 a year to convert every one of his major nonexempt assets into sheltered property on the eve of bankruptcy with actual intent to defraud his creditors and then emerge washed clean of future obligation by carefully concocted immersion in bankruptcy waters.

Reed asserts that denial of a discharge makes the exemption meaningless. This is but fulmination. Reed may retain his home, mortgages substantially reduced, free of
claims by his creditors. In light of the ample evidence, aside from the conversion itself, that Reed had an actual intent to defraud his creditors, he simply is not entitled to a discharge despite the fact that a generous state law may protect his exemption. The argument that we should reject the other ground for denying discharge gets but the short shrift it deserves.

III

The district court found that Sharon Marcus Reed benefited from the "prohibited activities" and possibly had knowledge of them but that she did not participate in them. Accordingly, he granted her discharge. The evidence showed that Sharon Reed made out the daily reports of the sales receipts of Reed's Men's Wear during the time that Reed was surreptitiously diverting those receipts to a bank account unknown to his creditors and management consultant. From this, it would have been possible to infer that Sharon Reed shared her husband's fraudulent intent, but the bankruptcy judge's findings to the contrary are not clearly erroneous.

The dual Reed opinions show how the courts have tried to negotiate a line that provides protection for a debtor and yet does not permit debtors to take undue advantage. It also illustrates how courts may see themselves bound by the legislature, as Judge Brister did in the bankruptcy court in Reed, or how they can read extremely open-ended language to craft what they believe is a more sensible solution, but one that defies precise definition.

In the debates leading up to the 2005 Amendments, Congress made its dissatisfaction with this approach evident. To respond to repeated complaints about millionaires who protect too much money in a homestead, Senator Herb Kohl, D-WI, proposed an amendment to cap permissible homestead exemptions at $250,000. States could continue to provide unlimited homestead exemptions to govern all state law collection suits, but anyone who wanted a federal discharge in bankruptcy would be limited to protecting no more than $250,000 in equity in a home. The amendment had widespread support, and during the long course of the bankruptcy bills, it passed the Senate more than once. But the then-governor of Texas, George W. Bush, and the senators from Texas threatened to block any bankruptcy bill with such a cap. In the final version of the amendments, the cap was dropped.

Congress rejected a homestead cap, but it did put some restrictions on the value that a debtor could protect in a homestead. The 2005 Amendments included a provision to reduce the dollar value of the homestead protection by any amount that is attributable to otherwise non-exempt “property that the debtor disposed of . . . with intent to hinder, delay or defraud a creditor.” §522(o). To catch even long-time planners, the provision has a ten-year reach-back period. This means, for example, that if the next court finds that the next Mr. Reed disposed of those non-exempt coins with an “intent to hinder, delay or defraud a creditor,” then in bankruptcy his equity in his homestead would be reduced by an equivalent amount.

Notwithstanding the change in bankruptcy law, the real joker in the deck remains: Not all debtors will be as forthcoming as Mr. Reed, especially after they (or their
lawyers) read about the outcome of *In re Reed*. Many conversions of non-exempt to exempt property are done with no intent to defraud anyone (think about paying on your mortgage with cash—technically a conversion of non-exempt property to exempt property under the Texas exemptions). Besides, the question remains whether planning activities to take maximum advantage of statutory exemptions are fraudulent or just plain sensible. Recall that even though the Fifth Circuit nabbed Mr. Reed with intent to defraud, not even Mr Reed’s own bankruptcy trustee who took the appeal to the Fifth Circuit claimed that he could prove actual intent to hinder, delay, or defraud his creditors—and Mr. Reed was a man who named his corporation “Triple BS.”

Congress added other restrictions to make it more difficult for well-heeled debtors to hide money in homesteads. It clearly signaled that it read the newspapers. In the wake of the mega-fraud Chapter 11 cases, reports emerged that former officers of Enron were building some scrumptious homes in River Oaks and other upscale Houston neighborhoods, perhaps with an eye on that Texas homestead exemption. Some newspapers even started running pictures of the luxurious—and exempt—homes of some of these executives. So Congress added another provision for an absolute cap on the homestead for people who were convicted of securities law violations, fraud in a fiduciary capacity, and a handful of other related bad acts. §522(q). If necessary, the discharge can be delayed to see if the debtor is subject to a proceeding that might give rise to a limitation of the homestead exemption. §§727(a)(12); 1121(d)(5)(C); 1328(h). Thus the bankruptcy law was “Enron-ized” to cut off protection for former big-time executives who might otherwise seek personal bankruptcy protection and try to shield assets in a huge home.

3. Unlimited Exemptions and Asset Trusts

The sound and fury over homestead exemptions overlook other unlimited exemptions. Courts around the country have been struggling with those for years.

One example came out of Minnesota. Dr. Tveten, a physician who dabbled in more than the healing arts, managed to amass $19 million in debts in a real estate partnership that went south. He consulted his attorney, who had two pieces of advice: convert your assets to protect as much as you can and file for bankruptcy. The good doctor took the advice, using seventeen transfers to sell off his land and liquidate his non-exempt life insurance and retirement accounts. All the transactions were for fair value. Dr. T put the money into about $700,000 of life insurance and annuity contracts with the Lutheran Brotherhood, a fraternal benefit association. Under Minnesota law, creditors could not attach these contracts. Best of all, the exemption has no dollar limit.

Dr. T conceded that the purpose of these transfers was to shield his assets from creditors. He wasn’t trying to cheat anyone, he said. He was just trying to meet the legal requirements of how he should best hold his assets. When Dr. T came up for a discharge in bankruptcy count, the bank that had financed the real estate deal and obtained his unsecured guarantee objected to his discharge. Norwest Bank Nebraska, N.A. v. Tveten, 848 F.2d 871 (8th Cir. 1988). The bankruptcy judge, following the analysis of the Fifth Circuit in *Reed*, denied the discharge, and both the district court and the Eighth Circuit affirmed.

But there was a stinging dissent in *Tveten* by Judge Arnold:
The Court reaches a result that appeals to one's general sense of righteousness. I believe, however, that it is contrary to clearly established law, and I therefore respectfully dissent.

Dr. Tveten has never made any bones about what he is doing, or trying to do, in this case. He deliberately set out to convert as much property as possible into a form exempt from attachment by creditors under Minnesota law. Such a design necessarily involves an attempt to delay or hinder creditors, in the ordinary, non-legal sense of those words, but, under long-standing principles embodied both in judicial decisions and in statute, such a purpose is not unlawful. The governing authority in this Court is Forsberg v. Security State Bank, 15 F.2d 499 (8th Cir. 1926). There we said:

It is well settled that it is not a fraudulent act by an individual who knows he is insolvent to convert a part of his property which is not exempt into property which is exempt, for the purpose of claiming his exemptions therein, and of thereby placing it out of the reach of his creditors.

Id. at 501. Thus, under the controlling law of this Circuit, someone who is insolvent may convert property into exempt form for the very purpose of placing that property beyond the reach of his creditors.... The same principle was confirmed by Congress when it enacted the Bankruptcy Code of 1978. The report of the House Judiciary Committee states as follows:

As under current law, the debtor will be permitted to convert nonexempt property into exempt property before filing a bankruptcy petition. See Hearings, Pt. III, at 1355-58. The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

In re Tveten, 848 F.2d at 877.

What made the Tveten case particularly noteworthy was that on the very day that it was announced the same court also announced the unanimous opinion in Hanson v. First Natl. Bank in Brookings, 848 F.2d 866 (8th Cir. 1988). The Hansons were South Dakota farmers who, on similar advice of counsel, sold all their non-exempt property, two vans, a car, a motor home, and all their household goods to family members. On agreement with the purchasers, the Hansons retained possession of many of the goods. They received the market value of the goods, $27,115, which they promptly used to pay down their mortgage and to buy exempt life insurance policies. Their lender bank objected to the Hansons' exemptions, wanting to reach the assets they had secreted. The court explored the same questions about whether the debtors had engaged in fraudulent conduct. The bankruptcy judge said the Hansons got their discharge and kept their newly exempt property. Both the district court and the court of appeal affirmed.

Judge Arnold sided with the majority in the second case, but he used the Hanson decision to sharpen his outrage in Tveten:

The Court is entirely correct in holding that there is no extrinsic fraud [in Hanson]. The money placed into exempt property was not borrowed, the cash received from the sales was accounted for, and the property was sold for fair market value. The fact that the sale was to family members, "standing on its own, does not establish extrinsic evidence of fraud." Ante, at 869.

With all of this I agree completely, but exactly the same statements can be made, just as accurately, with respect to Dr. Tveten's case. So far as I can tell, there are only three differences between Dr. Tveten and the Hansons, and all of them are legally
irrelevant: (1) Dr. Tveten is a physician, and the Hansons are farmers; (2) Dr. Tveten attempted to claim exempt status for about $700,000 worth of property, while the Hansons are claiming it for about $31,000 worth of property; and (3) the Minnesota exemption statute whose shelter Dr. Tveten sought had no dollar limit, while the South Dakota statute exempting the proceeds of life-insurance policies, is limited to $20,000. The first of these three differences—the occupation of the parties—is plainly immaterial, and no one contends otherwise. The second—the amounts of money involved—is also irrelevant, in my view, because the relevant statute contains no dollar limit, and for judges to set one involves essentially a legislative decision not suitable for the judicial branch. The relevant statute for present purposes is 11 U.S.C. §522(b)(2)(A), which authorizes debtors to claim exemptions available under "State or local law," and says nothing about any dollar limitations, by contrast to 11 U.S.C. §522(d), the federal schedule of exemptions, which contains a number of dollar limitations. The third difference—that between the Minnesota and South Dakota statutes—is also legally immaterial, and for a closely related reason. The federal exemption statute, just referred to, simply incorporates state and local exemption laws without regard to whether those laws contain dollar limitations of their own. . . . If there ought to be a dollar limit, and I am inclined to think that there should be, and if practices such as those engaged in by the debtor here can become abusive, and I admit that they can, the problem is simply not one susceptible of a judicial solution according to manageable objective standard.

As if the problem of fraudulent intent did not already have enough twists, a third case in the trilogy provides the O. Henry ending. It seems that more than one Minneapolis physician had bought into the bad real estate partnerships (had there been a targeted marketing to Minneapolis doctors?). Dr. Robert Johnson converted about $400,000 in assets into the same kind of exempt property as did Dr. T, on the advice of the very same attorney who advised Dr. T. The same bank made an objection to discharge based on the same facts. But Dr. J drew a different bankruptcy judge, and Dr. J got his discharge. Affirmed in the district court and affirmed by the Eighth Circuit. In re Johnson, 880 F.2d 78 (8th Cir. 1989). Equal justice under law.

The Eighth Circuit trilogy is notable for another feature that does not play a prominent part in the opinion. Both states let people squirrel away as much cash as they want in a Fraternal Benefit Association fund, free from the reach of their creditors.

Fraternal Benefit Associations? What’s going on with those? They sound so, um, pokey, but some lawyers have seen real potential in the idea of hiding all of a client’s assets so that they cannot be reached by creditors—whether the debtor eventually files for bankruptcy or not.

The device de jour is called an asset protection trust. The operation is fairly simple. For example, Ryan Spear transfers a big batch of his property to The Ryan Spear Trust, names himself as both trustee and beneficiary, then sits back and smiles. Ryan keeps right on using the property—driving the car, sailing the boat, dropping in on the winter place in Aspen and the summer place in Maine. If Ryan runs over someone with his Hummer or lets his attention wander and commits malpractice during open-heart surgery or does some other thing that gets him sued, the victim can take a judgment, but when she tries to seize the cars/boats/condos, Ryan smiles and says, “Sorry, but those aren’t mine. They are the property of the Ryan Spear Trust. The trustee lets me use them sometimes.”

The idea of a self-settled trust (self-settled because Ryan gave assets to a trust for which Ryan was the beneficiary) was anathema to trust law. Anything like
this looked like a plain old fraud on the creditors. And that remains the law in most places. But the key word is “most.”

A few years back, Alaska made self-settled asset protection trusts legal. Never one to pass up something that might generate legal fees, Delaware immediately jumped in and made them legal as well. (Yes, Delaware, the state that says ordinary folks can’t even keep a two-bedroom-one-bath home in a bad part of town said that debtors could establish asset protection trusts to place millions of dollars of assets out of reach of creditors.)

Competition for legal business in the emerging field of “asset protection” has heated up. Accounting Today, that sizzling magazine that covers all the sexy new trends in accounting, reports that eight states now permit asset protection trusts: Alaska, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota, and Utah. Best of all, many of these states make the trusts available to out-of-state residents. Ryan’s of the world start smiling. Unlike the Texas or Florida homesteads, the asset protection trusts are available without leaving home.

How widespread are these trusts? Click on Nexis and search for “asset protection trusts,” and you will probably turn up a batch of advertisements and notices like the one we saw in the June 27, 2005, Pittsburgh Post-Gazette. Nestled right in between announcements for the meetings of the Kiwanis Club of McKeesport and the Rotary Club of Pittsburgh, was this little gem:


How much value is tucked away in these accounts? In fact, how many of them are there? So far, we haven’t seen any numbers. We doubt that the typical cosmetologist has one, but we’re less sure about the average plastic surgeon.

A more exotic and expensive cousin is the offshore trust, established in the Cook Islands or other sun-kissed locales. (For extra credit, where are the Cook Islands?) Trusts are offered that purport to become unresponsive to the settlor’s instructions if those instructions are the product of “coercion.” The coercion might be provided, we suspect, by a federal judge. That way a debtor who is held in contempt for not producing the assets from a foreign trust can shrug and say, in all honesty, “Gee, your honor, even if I wanted to produce the assets, I couldn’t.” These trusts are being increasingly marketed to the risk-inclined and jury-wary across America. To the benefits of the self-settled trust they add distance and the fortress of national sovereignty.

What happens to asset protection trusts in bankruptcy? If they are structured right, including a spendthrift provision and an automatic appointment of a third party as trustee if the trustee-debtor is sued, the debtor will claim that the property in such a trust is not property of the estate. §541(c)(1). The reference in section 541(c)(1) to state law seems to give the trusts full protection, at least in eight states. Of course, in the same way that the funds placed with fraternal orders are exempt in Minnesota, the states intent on sheltering those who establish asset protection trusts can also make the property in them exempt from any creditor attachment, which would also be recognized in bankruptcy through section 522(b). In other words, excluding property
from the estate and exempting property from creditor attachment meet in devices that are separated more by paper forms than by any reality.

Asset protection trusts and their fraternal order cousins in exemption law could always be set aside by the approach taken in *In re Reed* by the Fifth Circuit: Even if the trust works at state law, the debtor will be denied the protection of a discharge in bankruptcy. This might work, but there remains a lot of room for debtors to litigate over intent. As the Eight Circuit indicated when it affirmed a discharge for Dr. Tveten’s colleague Dr. Johnson, what looks like fraud is far from certain. As a result, many people have begun to raise concerns about the possible use of these trusts and thought that the law should be amended to make it clear that this loophole was stitched up.

When the 2005 Amendments were pending, Senator Charles Schumer, D-NY, proposed that all assets in asset protection trusts be brought into the estate, and that the exempt portion be limited to a $125,000 cap. His amendment failed. Later, Senator James Talent, R-MO, introduced an amendment that passed in which he claimed to have fixed the asset protection trust problem. Others were less sure that the fix really works.

Senator Talent’s amendment is a ten-year reach-back for transactions made with intent to hinder, delay, or defraud creditors. §548(e). It is, of course, the basic approach of *In re Reed*, *In re Tveten*, and *In re Johnson*, with a long reach-back period (if needed). The problem once again is that determining intent is tricky. It is made trickier by the language in the Code that describes such transfers as fraud when they are “in anticipation of any money judgment” or to escape judgments in connection with securities fraud. These examples may limit the courts’ application of a fraud standard to those cases in which the debtor was clearly trying to avoid a particular claim. By negative inference, would this make other asset protection trusts all right?

So far as we know, the change in the bankruptcy laws has not slowed down traffic in asset protection trusts, and, just for good measure, the various state fraternal benefit associations remain open for business.

### 4. Moving to Better Exemptions

There is another way that debtors can plan to protect their property in advance of a bankruptcy filing: They can move from a state with stingy exemptions to one that is more generous. The problem, as in so many other areas of the law, is that some pesky judge may decide the move was not motivated by a strong desire to become a Buckeye, a Sooner, or even a Longhorn, and may treat the move as a form of impermissible exemption planning.

*In re COPLAN*
156 B.R. 88 (Bankr. M.D. Fla. 1993)
C. Timothy CORCORAN, III, Judge.

These contested matters test the limits of what some euphemistically call "pre-bankruptcy planning" by new Floridians who seek to benefit from Florida's nationally recognized liberal exemption laws. In this case, the debtors incurred substantial indebtedness in their home state of Wisconsin, moved to Florida, converted their non-exempt assets into property that is exempt under Florida law, and then filed a Chapter 7 petition here. They thus seek to discharge their debts and keep their newly "exempted" property. Upon the objection of their largest creditor and the Chapter 7 trustee, the court is required to call a foul, holding that the debtors have exceeded permissible limits. . . .

II. FACTUAL BACKGROUND

Before November of 1989, Lee and Rebecca Coplan resided in the state of Wisconsin where Mr. Coplan was engaged in business. Mr. Coplan had been employed for approximately 14 years by a Chapter S corporation known as Coplan's Super Appliance and TV, Inc., a company that owned and operated a retail appliance store conducting business under the name Coplan's Appliance & Home Entertainment Superstore. AT&T provided financing to the business through a line of credit and was the primary creditor of the business. Sometime in 1988, Mr. Coplan acquired a one-half ownership interest in the business from his father. In May of 1989, Mr. Coplan executed a personal guaranty in favor of AT&T Credit Corporation in replacement of the personal guaranty previously executed by his father.

By September of 1989, the business had deteriorated substantially. In fact, the debtors' 1989 tax return reflects that Mr. Coplan's 50 percent interest in the business resulted in a loss to him of $44,264 with a net loss to the business, as a whole, of $88,528 that year.

Mr. Coplan resigned his position with the business in November of 1989. He testified that he had decided to resign his position with the business in August of 1989, citing as reasons unhappiness with what he had been doing, a dishonest business partner, emotional stress relating to the job, problems with his parents, and deterioration in the performance of the company. Although Mr. Coplan interviewed with several companies in Wisconsin and received offers prior to his resignation, he did not accept employment with any company in Wisconsin. Mr. Coplan further testified that he relocated to Florida in pursuit of "job opportunities" with Amana and Disney, although he had no job offer from either of those companies and none was forthcoming until a considerable time after he moved here.

Subsequently, on November 29, 1989, the debtors closed the sale of their home in Wisconsin. The successful bid for the home was received and accepted almost immediately after the house was placed on the market. One day after the completion of the sale of the Wisconsin home, the debtors closed the purchase of the house located in Winter Park, Florida. They paid $228,000 in cash for the house, using virtually all of the proceeds obtained in the sale of the Wisconsin house. Thus, the Coplans completed the entire process of selling one home and purchasing another half way across the country in the space of less than one month. The Coplans then moved to Florida in December of 1989. Mr. Coplan's partner continued to run the business in Wisconsin.

In June, 1990, the business ceased operations.
On December 26, 1989, Mr. Coplan purchased an annuity from Pacific Fidelity Life Insurance Company for $20,932.29 with funds held by him in his individual retirement account (IRA). On the same day, Mrs. Coplan also purchased an annuity from Pacific Fidelity Life Insurance Company for $14,741.53 with funds held by her in her IRA. Mrs. Coplan did not work outside the home, and she had no earnings or compensation. She testified that her IRA had been funded in part by gifts made by her parents.

Sometime in early 1990, Park State Bank obtained a judgment in Wisconsin against the debtors jointly for approximately $50,000. In April of 1990, AT&T filed suit against Mr. Coplan in the United States District Court for the Eastern District of Wisconsin to collect on the guaranty. In July of 1990, AT&T obtained a consent judgment in its favor and against Mr. Coplan in the amount of $1,081,839.69.

In August of 1990, Mr. Coplan obtained full-time employment with Amana in Florida. Prior to that time, his only employment had been on a part-time basis as an appliance sales representative for Sears and Roebuck at a Sears retail store. During this extended period without regular employment, the Coplans liquidated nearly all of their non-exempt assets and used the proceeds on which to live.

On December 5, 1990, the debtors filed their petition under Chapter 7 of the Bankruptcy Code in this court. The schedules reflect that there was little or no non-exempt property available to the estate.

III. THE HOMESTEAD ISSUE

Pursuant to Section 541 of the Bankruptcy Code, the filing of a bankruptcy petition creates an estate that consists of all property of the debtor. The exemption of property which is ordinarily subject to administration by the estate is governed by Section 522 of the Bankruptcy Code. In this case, no one disputes that the debtors are bona fide Florida residents. Thus, the relevant exemption statutes are found in Florida law.

Article X, Section 4(a)(l), of the Florida Constitution provides that homestead property may be claimed as exempt to its full value and may thus be protected from the reach of creditors. The objectors do not take issue with this general proposition but argue that the debtors' right to exempt their homestead is subject to qualification where the exempt property has been impermissibly converted from non-exempt assets.

The central question in the instant case is whether, considering all the circumstances, the debtors' relocation to Florida with the attendant purchase of the Winter Park home was for the specific purpose of shielding their assets from creditors. The court concludes that it was.

If the debtors had retained their Wisconsin home, the judgments entered in favor of Park State Bank and AT&T would have attached to the property. Further, the house would have become an asset of the bankruptcy estate had the debtors filed for bankruptcy in Wisconsin. In addition, under Wisconsin law, the debtors would have been limited to an exemption of only $40,000 on their homestead, rather than its full value.

The objectors argue that the Coplans relocated to Florida solely for the purpose of obtaining the benefit of the generous Florida exemptions. In contrast, the debtors contend that their primary objective in relocating was to pursue job opportunities for Mr. Coplan and to alleviate stress. The debtors have suggested that Mr. Coplan,
despite the knowledge that the business was operating at a loss and had an uncertain future, refused one or more job offers in Wisconsin because of low salary and the desire to move and instead came to Florida in the bare hopes of obtaining better employment.

The Coplans’ testimony on these points is not credible. The evidence clearly establishes that the business was deteriorating in the months immediately preceding the move. In fact, the business posted a substantial loss for the 1989 year. Mr. Coplan was painfully aware that, in the event the business defaulted on its obligation to AT&T, he was personally liable. In addition, Mrs. Coplan admitted the debtors knew their house in Wisconsin was subject to forced sale to satisfy the claims of their creditors and that a homestead in Florida was fully exempt. More importantly, she acknowledged on adverse examination that the move to Florida was for the purpose of obtaining the more generous homestead exemption.

The debtors have further argued that the fact that the house was purchased more than one year before the date of the filing of their Chapter 7 case insulates the claim of exemption from objection. The foundation for their argument appears to be Section 548 of the Bankruptcy Code. That section provides a one year statute of limitations for actions to set aside fraudulent transfers. This matter, however, is not a fraudulent conveyance action, and Section 548 does not therefore apply. Instead, this matter is being decided on the basis of Section 522 [the exemption provisions]; in that section of the Bankruptcy Code, there are no strictures in regards to time as there are in Section 548.

In considering issues of this sort, however, the timing of the conversion of assets from non-exempt to exempt status is a factor to be considered in determining whether there was a specific intent to shield assets from creditors. As a general rule, all other things being equal, the more distant the conversion, the less likely the court will be to find that the conversion was part of a specific plan to exclude the property from the reach of creditors. Nevertheless, timing is just one factor to be considered in examining this question.

In the circumstances of this case, the fact that the debtors purchased the Winter Park house one year and five days before the filing of the Chapter 7 bankruptcy petition fails

2. Following the completion of the evidentiary hearing held on the objections to claims of exemptions, AT&T filed a motion to reopen the evidence (Doc. No. 43). AT&T alleged that the debtors perjured themselves in giving this testimony. AT&T sought the opportunity to present evidence to contradict the testimony the debtors gave. The debtors filed a responsive motion to strike (Document No. 47). The court heard the motions on December 4, 1991, and the court took the motions under advisement.

The court deems the motions to be moot and unnecessary because the court does not find the debtors' testimony, especially that complained about in the AT&T motion to reopen, to be credible. In addition to the internal inconsistencies in the testimony that were highlighted during adverse examination, the court carefully observed the demeanor of the debtors as they testified. The court is satisfied, therefore, that the debtors' testimony is unworthy of belief on these key points so that no purpose would be served by reopening the evidence. The court has therefore not considered for purposes of the motion to reopen, the responsive motion to strike, or on the merits of the contested matters the affidavits filed by AT&T and the debtors in support of their respective motions.

For these reasons, the court is contemporaneously entering a separate final order denying as moot the motion to reopen the evidence and the responsive motion to strike.
to save the exemption. The debtors are financially sophisticated; they were fully able to appreciate the personal financial ramifications of a faltering business. As soon as it became apparent that the business was failing, the debtors undertook a well considered and carefully orchestrated series of maneuvers for the purpose of shielding their assets from the reach of their creditors. They had the foresight and the resources to wait one year following the conversion of their Wisconsin homestead to a Florida homestead before filing their bankruptcy petition. In fact, although the debtors paid cash for the house, they systematically liquidated their non-exempt assets during that year. Because Mr. Coplan was unemployed for much of that time, the family lived on the results of this liquidation.

The fact that the filing so closely fell upon the expiration of the one year anniversary of the conversion of the property to a fully exempt form itself adds support to the court's conclusion that this was part of a well planned scheme. The debtors sold their home in Wisconsin in a rush. They selected and purchased the home in Florida in an equally fast fashion. The purchase price was, almost to the penny, the same as the net proceeds received from the sale of the Wisconsin home. The debtors then moved to Florida without any job commitment for the only breadwinner for the family, having rejected job offers in Wisconsin. Indeed, it appears the Coplans rushed here once they recognized the hopelessness of their business enterprise so they could put the maximum amount of time between the conversion of their assets and their inevitable bankruptcy filing. This case is plainly unlike the situation where, following conversion of assets, an unexpected disaster occurs that pushes a debtor into bankruptcy and thus necessitates a different treatment.

The actions of the debtors suggest a concerted effort to defeat the ability of their existing creditors to be paid the monies owed them by maximizing the exemption protections offered under Florida law. . . . [T]he court may not permit this manipulation. Thus, the exemption should be denied to the extent that the debtors achieved a benefit greater than their entitlement under Wisconsin law.

In this case, had the debtors not engaged in this pre-bankruptcy planning, or had they stayed and filed bankruptcy in Wisconsin, they would have been entitled to an exemption of $40,000 from the proceeds of the sale of their home. Accordingly, the court will allow $40,000 of the Florida home as exempt and will deny the exemption as to the remainder. The Florida home is therefore property of the estate subject to administration, although the trustee will be required to recognize that the amount of $40,000 is the exempt property of the debtors. Pursuant to the provisions of Section 363(f) of the Bankruptcy Code, the trustee may sell the property and distribute the net proceeds, after payment of ordinary and necessary expenses and costs of sale and closing, between the debtors and the estate as determined here. The court has previously utilized this methodology when a debtor has a legitimate homestead claim to some but not all of indivisible property. . . .

We haven't seen any evidence that Bowie Kuhn, Marvin Warner, and Martin Siegal are giving up their multimillion-dollar mansions, but the days of debtors fleeing to Florida to take advantage of the superior exemptions may be numbered. On the other hand, if Mr. and Mrs. Coplan had stayed out of bankruptcy and fought with their creditors through the Florida state courts, they might still have their home today.
In this area, Congress decided it did not want to rely on the bankruptcy judges to exercise discretion in weeding out bad cases, so the 2005 Amendments include a provision to limit the ability of a debtor to move to take care of better exemptions. In effect, the new provisions are a sort of choice-of-law provision for exemptions.

What exemptions will govern a debtor’s filing? According to section 522(b)(3), the applicable exemptions will be wherever the debtor resided for 730 days (two years in the parlance of ordinary speakers of English). What if the debtor moved during that time? Then go back to the 180 days that precede the 730 days and see where the debtor was for the majority of that time (e.g., the six months before two years before filing). People who move a lot might find themselves in bankruptcy, governed by exemption laws from three or four moves previously. Our data show that debtors in bankruptcy have moved around more than most people.

Not all state exemption laws were written for the twists and turns of federal bankruptcy law, however. Many protect only a homestead “in the jurisdiction” or property held locally. That could mean that a debtor who left the state a year or two ago would be eligible for exemptions nowhere—the debtor’s property would all be in the new state and the debtors’ exemptions under section 522(b)(3) would be only for property in the previous state—of which there was none. In such a case, the statute commands the debtor to use the federal exemptions, even in states that do not permit such use. It seems that the unlimited homestead exemptions will remain available to real Texans, except those who left and returned.

The consequences of this provision should provide some unusual entertainment as the bankruptcy judge in the Middle District of Tennessee must suddenly learn to interpret the state exemption laws for Alaska for someone who moved to Nashville from Anchorage a year-and-a-half ago. Moreover, the question of where someone was domiciled two-and-a-half years ago now has the potential to become yet another hotly litigated question—even for debtors who can barely scrape together enough money to hire a lawyer to prepare a bare-bones bankruptcy petition. The latter is a reminder that sometimes these attempts to sweep in the abusers also round up a lot of other folks as well.

5. Who Cares About Exemptions?

We began the section on exemptions with the guy in the barrel, thinking about why he might get to keep his clothes. We end the chapter with a Congress not willing to prevent multimillionaires from protecting unlimited assets, if they can negotiate a carefully laid out chicane. The policy grounds for this result remain elusive.

With all the talk about glutinous exemptions, we cannot leave without one final note. Michelle White, Professor of Economics at the University of California at San Diego, studied state exemptions and entrepreneurial start-ups. She concluded that the likelihood of a homeowner owning a business was 35 percent higher in states with unlimited homestead exemptions. Michelle White, Bankruptcy and Small Business, Regulation 18 (Summer 2001). She concluded that changing bankruptcy laws and narrowing exemptions would “discourage many entrepreneurs from going into business and some of the discouraged businesses would inevitably involve innovative new ideas that would have generated jobs and economic growth.”
And what about all the creditors who, at least in theory, recover less money in the high-exemption states? Surely they are charging debtors more in those states than in the ones that will let the creditors strip the debtor almost to his skivvies. A group of economists claimed to answer the empirical question with a yes, but they compared the rates on secured car loans that aren’t likely to be much affected by exemption levels. See Reint Gropp, John Karl Scholz, and Michelle J. White, Personal Bankruptcy and Credit Supply and Demand, 112 Quarterly Journal of Economics 217-51 (February 1997). (Indeed, the fact that they report finding something of statistical significance on secured car loans leaves us scratching our heads—we don’t know what is going on, but we’re pretty sure it isn’t the sort of rationality assumed in many law-and-econ models.)

In his dissertation at MIT, economist Fredrick Link examined the cost and availability of general unsecured credit (the debt that should have been affected by exemption levels) in states with high exemptions and those with low exemptions. He determined that the differences among the states were statistically indistinguishable. Fredrick Link, The Economics of Personal Bankruptcy (MIT June 2004). He also found that homestead exemptions were negatively correlated with homeownership, suggesting that state protection seems to yield fewer, not more, homeowners. His data make it clear that easy assumptions about how exemptions will affect incentives and market effects are likely to be wrong.

There has been a great deal of press about unlimited homestead exemptions and the unsavory characters who seem to be attracted to expensive homes. Interestingly, the stingy homestead exemptions that will cost people their homes in low- or no-exemption states has drawn little press attention. During the debates over the 2005 Amendments, Senator Russell Feingold, D-WI, proposed a floor on homestead protection for older Americans. Anyone 65 or older could protect equity in a homestead up to $125,000 in value, regardless of state exemptions laws or state opt-outs. The amendment was defeated, but the issue is like to arise again. With exemptions, it seems, the debate is never quite over.

Problem Set 9

9.1. Kevin LoVecchio is has been battling with a host of angry former partners in a real estate business scheme, and it appears they are closing in. Last week they got a $10 million judgment in a contract law action against him.

Kevin, a law school grad who never wanted to settle down and practice law (“too boring”), has a gorgeous penthouse condo in Manhattan, very near The Donald, and not much else (“temporary slump”). He has lived in the condo for five years, except for a period about two-and-a-half years ago when he rented an apartment in Texas for 91 days (“moved there for business, but I couldn't take the heat”) and a period last year when he moved to New Jersey for a couple of months (“thought it would be cheaper, but it really wasn’t”). In both Texas and New Jersey he applied for a drivers’ license, registered to vote, and changed his address for all his magazine subscriptions. Kevin came to see you yesterday to ask that you file his petition for Chapter 7. Can he keep his condo? (New York permits a debtor to protect $10,000 in a homestead.) Does he face any other obvious problems?

9.2. You are a specialist in tort litigation. Caleb Wiley asks for your advice. He had a very unfortunate car accident that injured two people and completely destroyed
a 1996 Jaguar. The accident occurred 19 days after his car insurance had expired. From the facts Caleb recites, you are certain he will lose any lawsuit, and the only question will be how much the plaintiffs will win.

As part of your consultation do you inquire into what property your client currently owns? Do you give a detailed explanation of the law before asking any questions?

9.3. One of your best clients, Dr. Panoply, is an ob-gyn who is known and beloved throughout your community as a fine doctor and a community leader who always has time for charities. He comes to you and says, "I have never had a malpractice claim and don't know of any that might be coming, but I've heard so many frightening things and the malpractice premiums have become so extraordinary, I think I should try an asset-protection plan, like the kind my friends have." He wants to set up a trust to hold all his investments safe from juries "who apparently don't understand that medicine is an art, not a science." What suggestions could you make to him? What sort of state remedies should he fear and how would your advice help? Are there collection remedies that might threaten him no matter what? And so on.

After you discuss things with him awhile, he says, "I have to admit it's not just the malpractice thing. I have been in this terrible dispute with Stock, Lock, and Barrel, the well-known brokerage firm, and it's in arbitration and I am afraid they may win, to the tune of a million dollars." Does this fact change your advice?

9.4. You are the new legislative aide to Virginia Bethania Herring, the ranking member of the Judiciary Committee. Two amendments to the bankruptcy laws have just been dropped in the hopper, and she asks you to give her a preliminary assessment on each.

- Drop the categories in 522(d) and simply put in a dollar amount. Debtors can protect any value up to that amount, regardless of how they hold the asset.
- Establish uniform federal exemptions that do not permit state opt-out.

What do you tell her?

E. CLAIMS AND DISTRIBUTIONS

1. The Claims Process

Once it is clear what property belongs in the debtor's estate and what property the debtor may properly exempt, the trustee begins to assemble any non-exempt property for sale. The proceeds will be distributed pro rata to the creditors. In order to give each creditor the appropriate share of the bankruptcy estate, the trustee's attention now turns from the debtor to the creditors.

Ordinarily a creditor will receive a proof of claim form (Official Form No. 10) with the notice of the bankruptcy. The form is a simple one. Its completion and filing are
governed by Rules 3001-3008, Fed. R. Bankr. P. The most notable requirement is that a claim based on a writing must have a copy of the writing attached.

In Chapter 7 and Chapter 13 cases a claim must be filed within 90 days after the first meeting of creditors, with certain exceptions. Fed. R. Bankr. P. 3002. In Chapter 11 cases, the court fixes a "bar" date before which claims must be filed. Fed. R. Bankr. P. 3003. A creditor must file a claim in Chapter 7 or 13 cases in order to receive a dividend, even if the creditor was listed on the debtor's schedules. Fed. R. Bankr. P. 3002. In Chapter 11, a creditor who is scheduled by the debtor is not required to file a proof of claim to receive payment. Fed. R. Bankr. P. 3003.

To receive any distribution, each Chapter 7 or Chapter 13 creditor must submit a proof of claim. The proof is simple, but practitioners say that some creditors inevitably fail to file in consumer cases. In Chapter 7 cases the habit of non-filing might be understandable since so few cases involve non-exempt assets and any dividend for distribution to the creditors. In Chapter 13 cases, however, where there is typically some payout for all creditors, failure to file is more surprising, but evidently still quite frequent.

A claim is allowed unless a party in interest makes an objection. §502(a). If a party objects, the dispute is resolved as a "contested matter" under Rule 9014, unless the objection also makes a demand for a type of relief that converts the matter into an adversary proceeding under Rule 7001. An example of the latter is a demand to void a preference, which we discuss later.

Later in this book we take a look at more complex claims questions, including warranties and other contingent obligations and future claims based on past wrongdoing. For now—for the average consumer case—we stick to the most recurrent issues: calculation of a claim, resolution of disputed claims, and the different treatments available for secured, unsecured, and priority claims.

2. Disputed Claims

Most claims in a consumer bankruptcy are presented for payment and are paid pro rata without objection by the trustee. It is worth a moment's reflection to note the remarkable thing that has happened: A number of claims are satisfied through the court without any state or federal adjudication that the money is owed. The parties simply agree, and the trustee, representing the interests of all the creditors, ratifies the claims of each creditor. This event illustrates the efforts taken in bankruptcy to spend the available money on distribution to the creditors rather than on litigation about which creditors are entitled to collect. Parties often agree in bankruptcy when they might continue to disagree in a non-bankruptcy context. Because the distributions are often modest, many creditors find that their enthusiasm to pursue a claim is also modest. Similarly, once a debtor has filed for bankruptcy, if the claim is to be discharged anyway, the debtor may have little incentive to spend money fighting rather than settling a claim. Of course, the debtor's lack of interest is precisely why the TIB must review the claims and make the final decisions on whether to challenge them.

In some instances, a TIB may object to paying certain creditors. Most often the trustee argues that there was no valid debt under state law or that the amount of the debt was lower than claimed. These instances are rare, but the threat of their arising serves to police creditor claims and to give the trustee negotiating leverage on doubtful claims. As the following case illustrates, resolution of the claim dispute sometimes requires an evidentiary hearing, much like the trial of a lawsuit. One twist in the case is that although
the trustee usually brings such an objection while acting on behalf of the estate, here the debtor brought the objection, for reasons we can safely ignore.

In re LANZA  

Emil F. GOLDHABER, Judge:  
The pivotal inquiry brought before the bench on the debtor's objection to a bank's proofs of claim, is whether the evidence supports a bank's entitlement to the three claims at issue, notwithstanding its apparent gross deviations from standard banking practice. After carefully weighing the evidence, we will reduce the amount of the first claim but uphold the remaining two in full. First Peoples National Bank ("the Bank") filed three proofs of claim. In support of the first proof of claim (No. 15) it appears that the debtors conveyed a mortgage on a parcel of real estate to the Bank in exchange for a construction loan with which to improve the subject property. This mortgage was executed for a denominated indebtedness of $200,000.00, although only $125,000.00 was advanced at settlement. The Bank later advanced $170,000.00 to the debtors through a series of unsecured loans, none of which, the Bank concedes, were charged against the original mortgage. Apparently, after some criticism of these advances from its auditors, the Bank convinced the debtors to grant another mortgage for $350,000.00 using the now improved property as collateral and allocating $125,000.00 of the proceeds to satisfy the original mortgage and $177,520.00 to discharge the unsecured indebtedness and interest. The mortgage was then properly filed and recorded. At the hearing the Bank presented conflicting testimony on the outstanding balance remaining on the mortgage and, weighing this discrepancy against the bank, we adopt the lowest figure presented by the Bank—namely, $300,000.00.  
The second proof of claim (No. 14) is based on a demand note and a properly recorded mortgage which secures a principal debt of $24,500.00, plus interest to date, for a total sum of $40,282.60. No evidence refuting this claim was introduced and we adopt this figure.  
Under the third proof of claim (No. 13) the Bank asserts an outstanding unsecured indebtedness of $27,639.62.  

Apparently finding the expansive relief of the automatic stay insufficient succor in this creditor-ridden world, the husband-debtor met his ultimate demise during the pendency of this proceeding. . . . Not a scintilla of first hand testimony on the transactions under scrutiny was offered. The wife-debtor professed ignorance of all her husband's financial dealings. The Bank, possibly cowering under the far graver spectre of intentional malfeasance, offered shockingly little evidence in support of loans totaling approximately one-third of a million dollars. The examples of so-called bookkeeping for a public financial institution that were presented to us as evidence could easily warrant for a half-dozen or so loan officers an other-worldly judgment  of perdition, forever.

3. Plaintiff's exhibit of the original demand note includes a notation that interest was paid to May 7, 1981.  
4. We of the bankruptcy court could enter no such final judgment, the subject matter not being a core proceeding since that power is justifiably reserved to a higher "judicial" authority.
condemning them to scramble about the floor of Pandemonium, each looking for the missing beads of his shattered abacus.

Notwithstanding her apparent ignorance, the wife-debtor, nonetheless, failed to present any evidence to undercut the Bank's moribund case. Although it is said that, "You can't take it with you," the husband-debtor apparently did take with him every financial record of "it" that he ever possessed. Not so much as a check stub supported the debtors' case.

As a preliminary point in our brief discussion, the Bankruptcy Rules state that a "proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim." Bankruptcy Rule 3001(f). "It follows, that the burden of going forward with the proof is on the objecting [party], not the claimant. That burden is not satisfied by the mere filing of an objection." In re Trending Cycles for Commodities, Inc., 26 B.R. 350, 351 (Bankr. S.D. Fla. 1982). All parties are in apparent agreement that monies were lent and liabilities incurred and, thereby, the principles underlying Rule 3001, and its applicability to the case before us, are bolstered. In short, as will be seen below, the Bank did not win this case; the debtors lost it.

On the first claim, the debtors argued that the lack of supporting documents and mismanagement of the file should invalidate the Bank's claim. However, as stated above, the burden of proof is not on the Bank to substantiate its claim with extensive documentation, the onus is on the debtor to overcome the presumption of validity. Although the court recognizes the wife-debtor's hardship in supplying this evidence, without guidance or her husband's records, the law is clear that with no evidence offered by the debtors to invalidate the loan or the properly recorded mortgage, the claim must be upheld. However, because of conflicting statements by the Bank's own employees on the balance of the indebtedness, we adopt the Bank's lowest figure of $300,000.00. The Bank should rightfully bear the burden of the ambiguity in light of its abysmal bookkeeping.

We found above that on the second claim the Bank has a secured indebtedness of $40,282.60 and on the third claim the Bank holds an unsecured indebtedness of $27,639.62. The facts on these claims are virtually undisputed, rendering any further analysis unnecessary.

On the debtor's objection to the Bank's three proofs of claim we will accordingly enter an order to reduce the first claim to the secured amount of $300,000.00, uphold the second secured claim in the sum of $40,282.60, and uphold the third claim in the unsecured amount of $27,639.62.

This kind of detailed fact-finding and dispute resolution is routinely handled by the bankruptcy courts in a relatively short time. Courts will usually consider the papers filed by the parties and schedule an hour or two to hear evidence. A disputed claim that might drift through the state court for years may be resolved within a matter of weeks in a bankruptcy forum.

But here, as elsewhere, a changing world is putting different pressures on the bankruptcy courts. Today, the thought of a bank making a loan and keeping that loan while the debtor repays is, in some circles, charmingly quaint. Instead, many lenders
package up their loans, almost as they would box up radios from an assembly line, and ship them off to investment consortia that will discount the face value of the loans and pay in cash for the future stream of income from the loans. Of course, those consortia may not hold on to the debts for long either. In the case of mortgages, for example, so-called “servicers” may collect from the customer and return the cash to an ever-changing group of investors. The difficulties arise, of course, when a customer claims that payments have not been properly recorded or charges have been added that should not have been. The scramble to find a paper record may prove as fruitless as it did in Lanza.

Yet another practice has complicated the claims procedures. Creditors may sell accounts after the debtor files for bankruptcy, further complicating the claims process because the paper they buy has the total amount due, but not the breakdown of the claim between principal and interest, fees, and other add-ons that are required in the bankruptcy rules. John Rao, of the National Consumer Law Center, explains:

The [claims filing rule] has become a “hot topic” primarily because of the rapid expansion in the market for sale of charged-off debt.1 Preferring not to deal directly with customer bankruptcies, many credit card companies and other creditors are increasingly selling their bankruptcy accounts to debt buyers for pennies on the dollar.2

This growth of the debt buying industry has transformed the bankruptcy claims process. Driven by the economics of the assignment process, debt buyers in particular have given short shrift to the Bankruptcy Rules. Rather than attaching cardmember agreements, promissory notes and account statements to proofs of claim, and providing itemized statements of interest and additional charges, debt buyers have been attaching to the claim form a one-page “Accounting Summary” that provides the debtor’s name and account number and merely restates the balance owed listed in paragraph 4 on Official Form 10.3 Proofs of claim are filed in this manner without any actual review of loan documents or account statements because the supporting documents required by Rule 3001 are not provided to debt buyers. 4

John Rao, Debt Buyers Rewriting of Rule 3001: Taking the “Proof” Out Of The Claims Process, 23-6 ABI Journal 16 (July/August 2004). It seems that bankruptcy will remain

1. In comments submitted to the Federal Trade Commission, the Debt Buyers Association reported that the amount of debt sold had grown from $1.3 billion in 1993 to $25 billion in 2000. See http://www.ftc.gov/os/comments/dnccomments/04/debtbuyersassociation.pdf. In 2003, out of the estimated $75 billion in total debt sold, $43 billion was charged-off credit card debt. See Debt Buyers in the Public Eye, Darren Waggoner, http://www.creditcollectionsworld.com/cgi-bin/readstory2.pl?story=20040601CCRU262.xml.

2. For example, one debt buyer purchased $8 billion of consumer bankruptcy debt last year, paying between a fraction of a cent to 3.5 cents on the dollar for chapter 7 debt and between 6 to 12 cents on the dollar for chapter 13 debt. See “Firm Finds Gold in Heaps of Debt,” Puget Sound Business Journal (Feb. 4, 2004).


4. Debt buyers are given a computer disk from the selling creditor containing the account summary information used to generate the proof of claim. Documentation and other information may be provided only upon request.
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an ever-changing system and that the judges will continue to have plenty of disputes to resolve.

3. Unsecured Claims

a. The Claim

The typical claim is not disputed by the trustee or the debtor. Section 501 lays out the procedure for filing the claims, and section 502 explains the mechanics of calculating a claim. All pre-petition claims, secured and unsecured, must begin with a §502 calculation. This section is the beginning point for claims against the debtor.

An example may illustrate: A debtor had a charge account with Sears. The terms were cash in full within 30 days or interest thereafter at an annual rate of 12 percent (unrealistic, but it keeps the calculations easy). Sears was also entitled under the agreement to attorneys' fees and costs of collection equal to 20 percent of the debt if it had to take any legal action to collect (a fairly standard clause in credit agreements). At the date of bankruptcy the debtor had made one charge for $1,000 and was three months late in paying, and Sears had begun collection efforts. Sears would file a proof of claim for $1,000, plus $30 interest for three months before bankruptcy (simple interest, not compounded, which is also unrealistic, but again it keeps the calculations easy). Sears would claim the $200 it spent on collection costs, for a total of $1,230. Under section 502 Sears is entitled the full amount as an allowed claim because all of the amounts are treated as having accrued before bankruptcy and therefore are pre-petition claims.

After the non-exempt assets have been sold, if there are proceeds equal to 10 percent of the total unsecured claims (10 cents on the dollar), the TIB will send Sears a check for $123. The difference between what Sears will be "allowed"—the same amount as in a nonbankruptcy lawsuit—and what it gets—a percentage of what it had coming—is the amount to be discharged at the conclusion of the case. In this case, the debtor would discharge $877.

b. Interest

It will probably take some time for the estate to be liquidated and Sears to get paid. If five months elapse between the bankruptcy filing and the distribution, does Sears get another $50 interest? If Sears is an unsecured creditor, the answer is no. Assuming someone objects, Sears will be denied the opportunity to collect any interest on its unsecured claim after the filing and while the bankruptcy is pending. §502(b)(2). In the terms of the statute, that would be interest that was "unmatured" on the date of bankruptcy. Admittedly, "unmatured interest" is like "unfallen rain"—a concept only a lawyer could love. Nonetheless, the phrase emphasizes that unsecured creditors get no post-petition interest, even if someone tries to claim that the interest was somehow owing before bankruptcy although "unmatured." When might someone claim unmatured interest? A loan that provided for a lump sum of interest rather than interest calculated over time would be reanalyzed by a bankruptcy
court to determine the portion of interest that was mature and the portion that was
unmature as of the instant of filing.

There is no doubt that the delay in distribution is costly to Sears. It loses the
time value of money, and yet it can make no claim for interest after the bankruptcy is
filed. The reason for this provision is based on the pro rata distribution among
unsecured creditors in bankruptcy. The amount available for distribution doesn't
increase, and each unsecured creditor will get the same proportion of the estate regardless
of whether or not interest is granted. Some creditors will have high interest rates by
contract and others will have low or no interest running. By treating all unsecured
creditors the same—that is, all collect a pro rata share of whatever remains of the estate—
bankruptcy reinforces the goal of equality among these unsecured creditors.

c. Accelerated Claims

The overwhelming majority of claims are obvious, undisputed obligations that the
debtor incurred before filing. But because all of the debtor's obligations are about to be
resolved in a single forum, once and forever, there exists a need to accelerate all pre-
bankruptcy claims whether they have matured or not. This acceleration of claims has
few parallels outside bankruptcy law. As a result, sometimes the claims process can
involve much more difficult and esoteric questions than resolution of disputed claims or
calculation of the amounts owed. A debtor who has guaranteed a loan before the
bankruptcy filing, for example, has an undisputed pre-petition obligation. But the
debtor may or may not have to pay, and the amount to be paid will change depending
on how many payments the primary obligor made before defaulting. Figuring out how
to value the guaranty claim can be difficult. Or a debtor may have engaged in some
conduct that will injure another, but the injury has not yet manifested itself. Or perhaps
the debtor has polluted, and both the pollution and its effects remain unknown. These
valuation questions all end up in the lap of the bankruptcy judge to be sorted out.

4. Secured Claims

a. The Claim

If Sears has a secured claim the first part of the calculation remains the same. Sears
can show what it is owed pre-bankruptcy through the calculation of a section 502 claim,
and the TIB can raise any contract defense. But as creditors line up for payment in a
liquidation bankruptcy, initiates rapidly find that the oft-repeated maxim "equity is
equality” takes on unexpected meanings. The largest differentiation among creditors is
the distinction between the treatment afforded creditors with valid security interests and
that given to their unsecured companions. Section 502(b) governs the permissible nature
and extent of an allowed pre-petition claim, while section 506 sets forth the special post-
petition and collection rights of secured creditors. An unsecured claim that is established
as valid is an "allowed unsecured claim" while a valid secured claim is an "allowed
secured claim" (perhaps you detect a pattern here).

Section 506(a) grants a secured creditor an allowed secured claim up to the value
of its collateral. If the claim is less than or equal to the value of the collateral, then the
entire claim is secured, or in the parlance of bankruptcy professionals, "fully secured."
If the claim is greater than the value of the collateral, then the claim is "partially secured." The remaining portion of the initial claim continues as an unsecured claim against the estate.

The typical treatment of a secured creditor is illustrated by another purchase from Sears. The debtor bought a top-of-the-line riding lawnmower from Sears, and Sears took a security interest in it. In the first example, the debtor has made substantial payments and at the time of filing Sears is still owed $5,000 on a lawnmower that is worth $6,500. The TIB sells the lawnmower and clears $6,000, after deducting advertising expenses and other costs of sale. §506(c). Sears has an allowed secured claim under section 506(a) for $5,000, the amount of its claim against the estate, and it gets $5,000 from the proceeds of the lawnmower sale. Sears is paid in full, and the remaining $1,000 goes to the general fund for distribution to unsecured creditors.

If, however, the lawnmower had been ridden hard and wrecked a time or two, it might bring only $3,500. In that case, if the TIB sells it and clears $3,000 after expenses, then Sears will have an allowed secured claim for $3,000 with an unsecured claim for $2,000 (the difference between the section 502 claim and the allowed secured claim). In that case, Sears would get $3,000 from the distribution following the sale. The entire distribution of the sale of the lawnmower would have gone to Sears, leaving nothing for the general fund. In addition (assuming ten cents on the dollar pro rata distribution to the unsecured creditors), Sears would have received another $200 on the unsecured portion of the claim, for a total of $3,200. In effect, an undersecured creditor gets a bifurcated claim under section 506: a secured claim equal to the value of the collateral and an unsecured claim for the deficiency. This isn't nearly as good as if Sears had been fully secured and collected the full $5,000, but it isn't nearly as bad as if the claim were unsecured and Sears had collected only $500.

b. Interest

Another important difference between secured and unsecured creditors is in their entitlement to interest for the period following the filing of the bankruptcy petition. Both secured and unsecured creditors are entitled to interest accrued prior to bankruptcy, assuming that their agreements with the debtor so provided. As we have seen, however, an unsecured creditor cannot claim any interest for the period following bankruptcy. §502(b)(2). Some secured creditors, however, may be able to get post-bankruptcy interest under section 506(b). If the secured creditor is oversecured, i.e., if the value of the collateral exceeds the pre-bankruptcy debt (including pre-bankruptcy interest), then the secured creditor can receive post-bankruptcy interest at its contract rate, until the value of the collateral is exhausted.

In the two examples above, Sears could have collected interest in the first, but not in the second. Where the value of the lawnmower ($6,500) exceeded the allowed claim ($5,000), Sears would have had an allowed secured claim for $5,000 and it would have collected interest on that amount during the pending bankruptcy. The amount would have continued to grow and compound until it reached the amount that could be realized from the sale of the collateral, which means that in our example Sears could have collected up to another $1,000. If the bankruptcy dragged on after that point, it would have collected no more interest. In the second example in which the claim exceeded the value of the collateral, Sears could not have collected any interest.
c. Attorneys’ Fees

Attorneys’ fees incurred prior to the filing of the bankruptcy petition are treated the same as pre-petition interest: If a creditor, secured or unsecured, is entitled to pre-petition attorneys’ fees by contract or state law, then the fees are part of the creditor’s secured or unsecured claim. However, the situation as to post-petition attorneys’ fees is less clear.

Secured creditors who are oversecured are clearly entitled to post-petition attorneys’ fees, until the total claim exceeds the remaining value of the collateral. §506(b). In our view, unsecured creditors should not be able to claim post-petition attorneys’ fees, just as they cannot claim post-petition interest, because section 502(b) is limited to pre-petition claims, while section 503, which governs post-petition claims, permits post-petition attorneys’ fees only under special circumstances. This conclusion is supported by section 506(b), which grants post-petition fees to oversecured creditors, thus showing that Congress knows how to grant post-petition fees when it so desires. Notwithstanding what we believe to be a fairly clear statement in the Code, the case law is somewhat more confused. The Second Circuit in In re United Merchants and Manufacturers, 674 F.2d 134 (2d Cir. 1982) granted post-petition fees and costs to an unsecured creditor in a case decided under the old Act but with language that strongly suggests that the results would be the same under the Code. The result in United Merchants is supported by the absence of a prohibition of post-petition attorneys’ fees in section 502(b). Because post-petition interest is expressly prohibited by section 502(b)(2), the lack of a similar provision barring post-petition attorneys’ fees suggests that they may be claimed by unsecured creditors under section 502. We would respond that the reason for the prohibition in section 502(b)(2) is that unmatured interest is often claimed outside of bankruptcy, while no one has yet asserted a right to unmatured (i.e., unearned) attorneys’ fees, so Congress would not have thought to prohibit them specifically.

Other courts, such as the Third Circuit in Adams v. Zimmerman, 73 F.3d 1164 (3d Cir. 1996) explicitly reject the result in United Merchants, summarizing the law:

Pre-petition attorneys’ fees of unsecured creditors against an insolvent debtor are generally allowed under the bankruptcy code to the extent the applicable state law so provides, and post-petition attorneys’ fees are generally not allowed [citations omitted]. Plaintiffs are entitled to attorneys’ fees that had accrued as of the date of the involvency but are not entitled to attorneys’ fees following the insolvency.

We are told by our friends in the bar that attorneys routinely claim post-petition fees, then wait to see if trustees object—which they nearly always do. Sometimes the dance among the repeat players in bankruptcy takes on the stylized elements of kabuki theater, but without the cool costumes.

d. Exemptions

Finally, it is worth repeating that valid, unavoidable consensual security interests trump exemption claims, so that a debtor may claim only an exemption in the “equity,” the value remaining after the secured creditor has been paid in full.
5. **Post-petition Claims**

Before leaving this example, we can anticipate a distinction that will be important in the next section. Suppose the TIB had decided to repaint some of the debtor's non-exempt furniture before selling it (in order to get a better price) and bought the paint at Sears on credit. Sears would have a claim, but it would be a post-petition claim and therefore made under section 503—"expenses of administration"—not section 502. Ordinarily Sears would be paid in full on its section 503 claims because these are administrative claims with a first priority in payment. §507(a)(1)-(2). We will explore priority claims in the next section when we discuss distribution.

**Problem Set 10**

10.1. Corinne Zeppo lost her job last month and filed a Chapter 7 liquidation bankruptcy this month. One creditor, Miller Plumbing Co., claimed $3000, plus (a) $200 in past-due interest accrued prior to bankruptcy; and (b) another $100 in interest accrued since the bankruptcy began. Interest was calculated for the pre-bankruptcy period according to the contract between Zeppo and Miller Plumbing and according to the state law judgment rate for the post-bankruptcy period. Miller Plumbing, however, has no security interest in any of Corinne’s property. What is the amount of Miller’s allowed unsecured claim in bankruptcy? See §502 (a), (b).

10.2. Corinne had only two non-exempt assets: her car, worth $10,000, and 1000 shares of MicroSoft stock, worth $15,000. At the time of filing, she owed the bank $8000 on the car and the bank had a valid and enforceable security interest in the car to secure its loan. In addition to the $8000 principal, the bank claimed (a) past-due interest that accrued prior to bankruptcy of $500; (b) interest since the bankruptcy was filed of $400, and (c) attorneys’ fees of $1000 expended in trying to collect. The bank was entitled to collect all these amounts under its loan and security agreement and under state law. What is the amount of the bank’s allowed secured claim in bankruptcy? §§ 502(b), 506(a), (b).

10.3. If, contrary to the pre-sale estimates, the car had brought only $5000 when it was sold, how would the bank stand? See §§ 502(b); 506 (a), (b).

10.4. Ten other creditors of Corinne are owed a total of $20,000, but none of them are claiming any interest. If you were appointed TIB in Corinne’s bankruptcy and collected $5000 for the car and $15,000 for the stock, how should you distribute the money (ignoring other expenses, including your own cut as TIB)?

6. **Priority among Unsecured Creditors**

After the secured creditors have been satisfied by the sale of their collateral, the unsecured creditors begin the process of dividing the remaining assets. The undersecured creditors, to the extent that the sale of the collateral did not satisfy their allowed secured claims, also join in this process.
Section 507 determines the order and amount of the payout to unsecured creditors. The unsecured creditors again find that "equity is equality" is not strictly the rule.

Problem Set 11

Harold Smith declared Chapter 7 bankruptcy in March 2005. His non-exempt assets consisted of his condo in Kitty Hawk, which the TIB sold for $400,000 but which was subject to a $365,000 mortgage, and miscellaneous personal property that sold for $25,000. All his other property was exempt. The claims filed in bankruptcy court were the following:

1. John Harry, a private duty nurse whom Harold hired while his father was quite ill: $11,000
2. Social Security Administration, social security and withholding from Harry's earlier pay checks: $534
3. City of Eden, property taxes: $3,000 per year for the last three years, plus $500 per year penalties for each of the three years
4. George Nartowski, down payment against a tractor lawnmower Harold had agreed to sell to George: $300
5. State Department of Revenue and IRS, income taxes: state $4,000, federal $14,000
6. Telephone, utility, and other regular bills following bankruptcy: $5,000
7. Sara Fleet, Harold's attorney: $1,250 in fees ($500 for a will; $750 for preparing this bankruptcy filing)
8. Suzan Smith, Harold's ex-wife, negotiable note: $25,000
9. TIB as trustee and as trustee's counsel: $4,000
10. Insurance premiums for insurance on the non-exempt personal property prior to its sale by the TIB: $750
11. Costs of sale of Harold's non-exempt real estate and personal property, including advertising: $2,800
12. Other unsecured, general claims: $17,000

Who will get what under sections 507 and 726(a)(4)?

F. DISCHARGE

1. Exceptions to Discharge

From an individual debtor's perspective, the purpose of a liquidation bankruptcy is almost always to discharge outstanding debt. Once the creditors' claims have been paid, the
debtor anticipates discharge from all remaining debt. In those courts that still require the debtor to attend, the discharge hearing is the second (and final) time the debtor will come to the courthouse. This time the debtor will appear before the judge, who will review the bankruptcy file, sign the papers declaring the debtor discharged from all listed debts, and close the case. Such hearings are usually mass affairs, with the judge making a few remarks to dozens of debtors gathered for the occasion. Nearly all courts now dispense with the hearing, instead mailing the discharge papers to the debtor on the theory that requiring a struggling debtor to lose a day's pay to attend a discharge ceremony is wasteful.

The debtor is not entitled to the discharge as a matter of right, but the discharge will be granted unless it is challenged by the trustee or a creditor. The trustee or creditors may object to the debtor's discharge of particular debts under section 523 or of all debts under section 727. It is important to remember the distinction between a section 523 denial of discharge and one made under section 727. The former renders only one debt nondischargeable (a "rifle shot"), while a denial of discharge under section 727 renders all of the debts nondischargeable (a "global" denial). Global denial of discharge leaves a debtor who has turned assets over to the trustee for sale and distribution with no relief from debt other than the actual payments made. Even a rifle shot denial leaves the debtor without complete relief and, if the debt was substantial, it may leave the debtor in almost as bad shape as before. For a creditor, of course, prevention of a discharge is usually the creditor's last remaining hope to receive any payment on the debt. As a result, when the grounds for denial of discharge arise they are more often hotly disputed than are other points of potential conflict in consumer bankruptcies.

The list of nondischargeable debts or the events for which a debtor can be denied any discharge at all continues to grow. In some cases the growth comes in response to unanticipated abuses that Congress wants to stop. In other cases, special interest groups have lobbied for an exception to the bankruptcy discharge. The categories of nondischargeable debts now number nineteen, a variety that now includes debts obtained by lying on a credit application, debts for luxury goods worth more than $500 obtained within 90 days of bankruptcy, fraud by a fiduciary, alimony and child support, and judgments resulting from drunk driving (or drunk boating) accidents. The grounds for total denial now number eleven, starting with the declaration that corporations do not receive discharges in Chapter 7 and continuing with denials of any discharge for debtors who have lied or filed false documents in connection with the bankruptcy case or failed to complete a personal finance course. The following cases reflect a sampling of the grounds for denial of discharge and a flavor of the courts' analyses.

First, a case involving a global challenge to the discharge.

In re Robert W. MCNAMARA, Debtor
310 B.R. 664 (Bankr. D. Conn. 2004)

ALAN H. W. SHIFF, Bankruptcy Judge.

***

Background
The debtor was the only witness at the trial. He testified that he had $150,000 in a briefcase as a result of numerous withdrawals from bank accounts during the summer of 1998 and that immediately after he was ordered to deposit the money in an escrow account, he gambled $130,000 in a winner-take-all stud poker game at a private residence in Brooklyn, New York. He was not able to provide any further details about the poker game except that someone, who no longer lives in the country, drove him there. In an effort to explain his failure to remember details, the debtor claimed that he was under the influence of alcohol and medication for severe depression. He further stated that he had just lost his job and had been taken to a hospital in New York with what he initially thought was a second heart attack. He did not, however, produce any evidence to corroborate that claim, such as medical or hospital records or the testimony of anyone who witnessed his condition. The debtor testified that he reserved enough money to pay for a Caribbean vacation, which was supported by receipts from that trip. He denied that he deposited any money into offshore bank accounts.

Apart from his difficulty to recall the details of the poker game, the debtor's credibility was also challenged by an unlikely difficulty recalling the details of significant bank account deposits and withdrawals prior to and concurrent with the alleged gambling losses. For example, he was unable to remember the source of an October 14, 1998 deposit of $44,247.87. He speculated that it was either from life insurance policies, despite testimony that other deposits were from those policies, or from his salary, even though it was a single large deposit, and he claims to have lost his job more than a month earlier. The debtor was also unable to credibly testify how he spent over $200,000 between June 1998 through February 1999. For example, he claimed that he spent a part of that money on renovations to his former marital residence, but the trustee reminded him that the property was sold in May 1998.

The evidence justified the trustee's suspicion that the debtor's claimed gambling loss in a fictional attempt to hide money that he considered to be his and not subject to his former wife's claims. He testified that he had an agreement with her that they would separate for five years rather than get divorced, so that he could maintain his health insurance through her employment. That issue was prompted by the debtor's claim that he was told he would require a heart transplant in the future. In return for her agreement, he claims to have agreed to give her custody of the children and repair the marital residence. The debtor testified that after she repudiated the agreement, he believed he was entitled to the $150,000:

I told her that if that was the case, that if she would not change her mind and go along with the agreement, that I would be forced to sell the house, take the $150,000 that I felt was mine. . . .

... I told her that I would take my monies—if she would not go along [with his plan to set up a trust] . . ., that I would be forced to sell the home, take the $150,000 that I felt . . . was my part. . . .
(Tr. of 11/8/00 at 56).
I had taken my 150 that I thought was mine.
(Tr. of 11/8/00 at 60).

DISCUSSION
11 U.S.C. §727(a)(5)
11 U.S.C. §727(a)(5) provides that the debtor shall be granted a discharge unless "the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities."

The plaintiff has the burden of introducing evidence of the disappearance of assets or of unusual transactions. The burden then shifts to the defendant to satisfactorily explain the loss or deficiency of assets. The test under this subsection relates to the credibility of the proffered explanation, not the propriety of the disposition. An explanation is not satisfactory if it is not offered in good faith or if it is vague, indefinite and uncorroborated. In re Maletta, 159 B.R. 108, 116 (Bankr.D.Conn.1993) (citations omitted).

The standard of proof is a preponderance of the evidence. Id. at 111.

The trustee satisfied her burden by her effective cross-examination of the debtor, which demonstrated that he could not recall any details to support his claim that he lost $130,000 in a winner-take-all stud poker game. A person who loses $130,000 in a poker game would be expected to have some recollection of the details of the event which could be corroborated, or at least a credible explanation for why he did not.

For the same reasons that the trustee has satisfied her burden of proof, the debtor has not. Although the debtor attempted to excuse his inability to recall any details on the claim that he was suffering from depression, he did not provide a scintilla of evidence to support that claim, such as a medical report or a witness testifying that he was in poor health. Apparently, his alleged condition did not interfere with his decision to reserve at least $11,000 for a Caribbean vacation, which supports the trustee's suspicion that he deposited money in offshore banks. The fact that the debtor withdrew the money over a period of months further supports the conclusion that he was formulating a plan to hide it from his wife.

***

11 U.S.C. § 727(a)(2)(A) provides in relevant part:

The court shall grant the debtor a discharge, unless—

(2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—(A) property of the debtor, within one year before the date of the filing of the petition.

A plaintiff under §727(a)(2)(A) must demonstrate that the act in question "occurred within one year prior to the commencement of the case; was performed with the actual intent to defraud a creditor or officer of the estate; was the act of the debtor or an agent of the debtor; and involved concealing, destroying, transferring, or removing any property of the debtor or permitting any of these acts to be done." Maletta, 159 B.R. at 115-16.

The debtor's schedules listed his former wife as a creditor, with a debt that is nearly all of his total liabilities. The parties agree that the alleged gambling occurred within one year of the bankruptcy filing.
[T]he debtor's testimony demonstrated he was angered by his former wife for breaking an alleged agreement not to divorce him, and he believed he was entitled to the $150,000. So, he took money he had been ordered to turn over to a state court escrow fund . . . and lost it in a poker game. In the best light, it was his intention to take a chance on either increasing the money, which would enable him to satisfy the court order and still keep the original amount, or lose it all. He cavalierly explained that his plan "didn't work out":

[A friend] told me about this gambling situation. I went to try to double the money so that I would have money for my medical and pay them off [his former wife and/or the court ordered escrow] before the 25th. It didn't work out. I lost. I then went on that vacation for ten grand or whatever it was.

(Tr. of 11/8/00 at 78). The debtor's testimony demonstrated he did not care that he lost the money because he believed it was his to lose and that his wife had no right to it. Bankruptcy is a privilege, not a right. ***

For the foregoing reasons, IT IS ORDERED that the debtor's discharge is denied under 11 U.S.C. § 727(a)(2)(A) & (5).

As with the cases discussed earlier in the homestead section (pp. 85-87), these discharge cases involve a great deal of judgment and discretion. In a case in Texas involving an elderly couple, the court in a thoughtful opinion accepted their explanation for the disappearance of large amounts of cash on the basis that South Texas ranchers often carry around a lot of cash to hire day laborers for work on the land. The fact that the debtors had disclosed everything was a major factor in the decision. In re Lee, 309 B.R. 468 (Bankr. W.D. Tex. 2004). In the opinion the court quoted a famous test to be applied to the phrase "explain satisfactorily" in section 727(a)(5):

The word "satisfactorily" . . . may mean reasonable, or it may mean that the court, after having heard the excuse, the explanation, has that mental attitude which finds contentment in saying that he believes the explanation—he believes what the bankrupts say with reference to the disappearance or shortage. He is satisfied. He no longer wonders. He is contented.

In re Shapiro & Ornish, 37 F.2d 403, 406 (N.D.Tex.1929).

Very different from a global denial is denial of discharge of just one debt. For certain kinds of rifle-shot denial under section 523(a), the creditor must object to discharge in bankruptcy court or the debt will be discharged automatically. §523(c).

In re DORSEY
120 B.R. 592 (Bankr. M.D. Fla. 1990)

Alexander L. paskay, Chief United States Bankruptcy Judge.
This is a Chapter 7 case and the matter under consideration is the dischargeability vel non of a debt admittedly due and owing by Dixie Lee Dorsey (Debtor) to American Express Travel Related Services, Inc. (American Express). ***

The Debtor is a widow and has two minor daughters. According to the Schedule of Current Income and Expenditures, she had no income during the relevant time period other than $480 per month received from Social Security. The fact of the matter is that the Debtor has not been gainfully employed since 1978 when she worked as a nurse's aid[e].

It appears that during the past four years the Debtor became involved with a gentleman known only as "Jimmy Jones," which she later learned turned out to be a fictitious name. According to the Debtor, Jimmy Jones supplemented her income by paying her bills and giving her between $2,500 and $6,000 per month as spending money. ***

The Schedules filed by the Debtor reveal that over the years the Debtor obtained seven American Express credit cards beginning with what is referred to as a personal card, i.e. the green card, a gold card, each with a credit limit, and an Optima card, which apparently has no credit limit at all. Not being satisfied that the credit extended to her through these cards would be sufficient to meet her need for credit, she also collected various other credit cards, which resulted in, according to her schedules, unsecured debts totaling $106,922.39.

It appears that the Debtor, at the suggestion of her mysterious boyfriend, Jimmy Jones, embarked on an extensive overseas journey with her children visiting every country in West Central Europe, including a side trip to the Greek Islands. The cost of this trip was charged by her on a program established by American Express referred to as "Travel & Sign." It appears that under this program, a cardholder is not required to pay the entire balance of the invoice submitted but is permitted to make only minimum monthly payments. Needless to say, incidental expenses, including purchases, on this trip were charged against her American Express credit cards. These charges included, among other things, perfume purchased in Paris for $784.21. In an attempt to explain this purchase she explained that she always liked to smell good. The purchase of this item, no doubt, triggered a not-too-well smelling sour note in the not very sensitive nostrils of American Express credit card department when it received notice of the filing of the Chapter 7 Petition by this Debtor.

At the time relevant, the Debtor resided in a mobile home in Winter Haven which, according to the Debtor, was burglarized while she was in Europe. ***

In defense of these undisputed facts, the Debtor claims that she incurred the American Express charges in good faith believing that Jimmy Jones would continue to furnish the funds necessary to meet these obligations. ***

This Court would be amiss not to make some initial remarks concerning this very unusual case. It is absolutely appalling to this Court and it is difficult, if not impossible, to comprehend how a responsible business enterprise like American Express would grant seven credit cards to a widow with two minor children who had no gainful employment since 1978 and whose sole regular income was, and still is, the munificent sum of $480 per month from Social Security. In defense of this astounding practice, the representative of American Express stated that as long as the cardholder meets the payment obligations, regardless of how many, they have no problem and do not care. This explanation obviously only begs the question and never furnishes a satisfactory answer to the question, why on earth American Express issued initially seven credit cards to a person
like this Debtor or any other person in a similar financial situation. Card issuers, including American Express, should not be surprised that from time to time individuals who are bombarded with unsolicited credit cards decide that so long as they have the card, they can use them and go on a charging spree without giving any thought to the fact that one day they will be called upon to repay the charges incurred.

The Court of Appeals of this Circuit had the occasion to consider the claim of nondischargeability based on misuse of credit cards in the case of First National Bank of Mobile v. Roddenberry, 701 F.2d 927 (11th Cir. 1983). This Court is not unmindful of the comments by Judge Hill, speaking for the Court, where it was stated that: "the element of risk is inherent in the issuance of bank credit cards. Our 'credit-card economy' encourages widespread voluntary risk-taking on the part of those issuing cards. Once credit cards are issued (if not fraudulently obtained), the bank has agreed to trust the cardholder and to extend credit, and once credit is extended, the bank must decide when and if credit will be revoked. It is not the function of courts to determine when a bank ought to revoke credit. It also is of little consequence that the bank can show that the terms and conditions said to apply to use of the card have been violated. The mere breach of credit conditions is of minimum probative value on the issue of fraud because banks often encourage or willingly suffer credit extensions beyond contractual credit limits. Indeed, banks have a definite interest in permitting charges beyond established credit limits because of the high finance charges typical in such transactions. In re Talbot, 16 B.R. 50, 52 (Bkrtcy. M.D. La. 1981). Banks are willing to risk non-payment of debts because that risk is factored into the finance charges." Notwithstanding these comments, while this Court agrees that merely exceeding the credit limit would not by itself be sufficient to form the basis of a claim of nondischargeability, fraudulent use of credit cards is another matter. Thus, if it is shown that at the time the Debtor incurred the charges he or she knew that they would be unable to live up to the obligation and pay the charges, or if it appears that they had no intention to pay the charges when the charges were incurred, that would clearly be an actual fraud thus rendering the debt incurred by using the credit card nondischargeable under Section 523(a)(2)(A).

If the Guinness Book of World Records would include the misuse of credit as a category of records in its publication, this Debtor certainly would have a fighting chance to get the first prize considering what happened in this instance. As indicated earlier, she is a widow with no income of any consequence on which she is to support two minor children, whereby using seven credit cards from American Express [and] from others, i.e. Visa and Mastercharge, she incurred unsecured debt in excess of $106,000. There is hardly any doubt that this Debtor was fully aware that she could never meet these obligations on her income even if she lived to be 100 years old, and her reliance on the continuing generosity of her mysterious boyfriend was unrealistic and unjustified to say the least. Although this relationship lasted four years, she claims they never lived together during those four years and she was not able to find out his real identity, she has no idea where he lives, and she certainly had no basis to believe that his generosity would continue forever.

Thus, it should be evident that this is not merely a claim of nondischargeability based on misuse of a credit card by exceeding the credit limits unlike the fact pattern in Roddenberry, supra, but involves obtaining money by actual fraud when she had no intention to pay these charges. The fact of the matter is, when questioned about her European trip, she stated, with some pride, that she had a grand time on her trip and enjoyed every minute of it.
Based on the foregoing, it is clear that whether the burden of proof required to prove a claim of nondischargeability is clear and convincing or merely preponderance of the evidence, American Express did establish with the requisite degree of proof that the outstanding balances of Account No. 1 and Account No. 2 should be excepted from the overall protection of the general bankruptcy discharge by virtue of Section 523(a)(2)(A).

***

A separate final judgment shall be entered in accordance with the foregoing.

One particular debt that has been singled out for special protection against discharge in bankruptcy is the student loan. While most people think of soon-to-be-rich doctors and lawyers waltzing into bankruptcy to discharge the debts they incurred through college and professional school, many people are struggling with loans incurred to learn to acquire skills that do not pay nearly so well.

In re GERHARDT
348 F.3d 89 (5th Cir. 2003)

EDITH H. JONES, Circuit Judge:

Over a period of years, Jonathon Gerhardt obtained over $77,000 in government-insured student loans to finance his education at the University of Southern California, the Eastman School of Music, the University of Rochester, and the New England Conservatory of Music. Gerhardt is a professional cellist. He subsequently defaulted on each loan owed to the United States Government.

In 1999, Gerhardt filed for Chapter 7 bankruptcy and thereafter filed an adversary proceeding seeking discharge of his student loans pursuant to 11 U.S.C. §523(a)(8). The bankruptcy court discharged Gerhardt's student loans as causing undue hardship. On appeal, the district court reversed, holding that it would not be an undue hardship for Gerhardt to repay his student loans. Finding no error, we affirm the district court's judgment.***

I. UNDUE HARDSHIP TEST

This circuit has not explicitly articulated the appropriate test with which to evaluate the undue hardship determination. The Second Circuit in Brunner crafted the most widely-adopted test. To justify discharging the debtor's student loans, the Brunner test requires a three-part showing:

(1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans. Brunner, 831 F.2d at 396.
Because the Second Circuit presented a workable approach to evaluating the "undue hardship" determination, this court expressly adopts the Brunner test for purposes of evaluating a Section 523(a)(8) decision.

A. Minimal Standard of Living

Under the first prong of the Brunner test, the bankruptcy court determined that Gerhardt could not maintain a minimal standard of living if forced to repay his student loans. Evidence was produced at trial that Gerhardt earned $1,680.47 per month as the principal cellist for the Louisiana Philharmonic Orchestra ("LPO"), including a small amount of supplemental income earned as a cello teacher for Tulane University. His monthly expenses, which included a health club membership and internet access, averaged $1,829.39. The bankruptcy court's factual findings are not clearly erroneous. Consequently, we agree with the bankruptcy court's conclusion of law, which we review de novo, that flows from these factual findings. Given that Gerhardt's monthly expenses exceed his monthly income, he has no ability at the present time to maintain a minimal standard of living if forced to repay his loans.

B. Persisting State of Affairs

The second prong of the Brunner test asks if "additional circumstances exist indicating that this state of affairs is likely to persist [for a significant period of time]." *Brunner*, 831 F.2d at 396. ***

Under the second prong of the test, the district court correctly concluded that Gerhardt has not established persistent undue hardship entitling him to discharge his student loans. Gerhardt holds a masters degree in music from the New England Conservatory of Music. He is about 43 years old, healthy, well-educated, and has no dependents, yet has repaid only $755 of his over $77,000 debt. During the LPO's off-seasons, Gerhardt has collected unemployment, but he has somehow managed to attend the Colorado Music Festival. Although trial testimony tended to show that Gerhardt would likely not obtain a position at a higher-paying orchestra, he could obtain additional steady employment in a number of different arenas. For instance, he could attempt to teach full-time, obtain night-school teaching jobs, or even work as a music store clerk.4 Thus, no reasons out of Gerhardt's control exist that perpetuate his inability to repay his student loans.

In addition, nothing in the Bankruptcy Code suggests that a debtor may choose to work only in the field in which he was trained, obtain a low-paying job, and then claim that it would be an undue hardship to repay his student loans. Under the facts presented by Gerhardt, it is difficult to imagine a professional orchestra musician who would not qualify for an undue hardship discharge. Accordingly, Gerhardt "has failed to demonstrate the type of exceptional circumstances that are necessary in order to meet [his] burden under the second prong" of Brunner. Finding no error, the judgment of the district court is AFFIRMED.

4. This is not meant to be an exhaustive list of possible employment opportunities for Gerhardt, but instead merely seeks to illustrate other viable avenues for income.
The Bankruptcy Court judge saw the case differently, noting that Mr. Gerhardt’s full-time job with the Louisiana Symphony Orchestra netted $14,609—his best year in five years. At the time he filed, Mr. Gerhardt was 43 years old, and he lived in a 600 square foot apartment, drove a six year old car, had no retirement plan and no savings. His mother owned his cello. The recovery arm of the student educational loan group that opposed his discharge was demanding more than $1000 of his monthly $1200 pay.

The following case reviews the legal standards applied by the courts to determine dischargeability, but permits a remedy not found in section 523.

In re Patricia M. MILLER, Debtor.
377 F.3d 616 (6th Cir. 2004).

OPINION

GIBBONS, Circuit Judge.

Miller received a Bachelor of Arts degree from Juniata College in 1988, a Masters of Arts in Philosophy from the University of Tennessee-Knoxville ("UT") in 1992, and worked towards a Doctorate of Philosophy at UT from 1992 to 1997. She failed to complete the requirements for the doctoral degree. To pay for her education, Miller received various student loans that are presently guaranteed by the Pennsylvania Higher Education Assistance Agency ("PHEAA"). After leaving UT, she requested and received forbearances and deferments on her student loans.

On May 30, 2001, Miller filed a Chapter 7 bankruptcy petition. Shortly thereafter, she filed an adversary action in the United States Bankruptcy Court for the Eastern District of Tennessee against PHEAA seeking discharge of all of her outstanding student loan debt, which totaled $89,832.16, as of April 26, 2002. At the time that she filed the adversary action, Miller had made payments of only $368.00 towards her student loans, an amount that represented less than half of one percent of her student loan obligations. Miller described her monthly expenses as follows:

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>rent</td>
<td>$395.00</td>
</tr>
<tr>
<td>utility payments</td>
<td>$75.00</td>
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<tr>
<td>cable television:</td>
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</tr>
<tr>
<td>telephone charges:</td>
<td>$90.00</td>
</tr>
<tr>
<td>cell phone expenses:</td>
<td>$40.00</td>
</tr>
<tr>
<td>internet service expenses:</td>
<td>$25.00</td>
</tr>
<tr>
<td>food:</td>
<td>$275.00</td>
</tr>
<tr>
<td>clothes:</td>
<td>$75.00</td>
</tr>
<tr>
<td>laundry:</td>
<td>$30.00</td>
</tr>
<tr>
<td>prescriptions, herbs, medical expenses:</td>
<td>$65.00</td>
</tr>
<tr>
<td>magazines/books:</td>
<td>$15.00</td>
</tr>
<tr>
<td>transportation (not including auto payments or repair work)</td>
<td>$110.00</td>
</tr>
<tr>
<td>auto payment with insurance:</td>
<td>$250.00</td>
</tr>
<tr>
<td>auto repairs and maintenance:</td>
<td>$100.00</td>
</tr>
</tbody>
</table>
Miller is single and has no dependents. As of 2001, her gross annual income was $26,464.00. In that same year, she received a gift of $3,000.00 from a friend and a $300.00 adjustment from the Internal Revenue Service. At the time of her adversary action, Miller was employed full-time as an administrative assistant at a construction company and part-time as a call center representative.

The bankruptcy court held a trial on April 30, 2002. The court found that all of Miller's student loan debts were not dischargeable pursuant to 11 U.S.C. §523(a)(8) because the full amount of the debts did not impose an undue hardship upon her. Notwithstanding this finding, the bankruptcy court granted Miller a partial discharge of her student loan indebtedness. The court decided that Miller's nondischargeable student loan obligation was $34,200.00 and accordingly dismissed the balance of her student loans, an amount of approximately $55,000.00. PHEAA appealed the judgment of the bankruptcy court to the United States District Court for the Eastern District of Tennessee. Miller cross-appealed. The district court adopted the opinion of the bankruptcy court and dismissed the appeals of both parties. PHEAA then filed a timely notice of appeal of the district court's decision.

II.

A discharge in Chapter 7 bankruptcy does not discharge an individual debtor's student loan obligations "unless excepting such debt from discharge . . . will impose an undue hardship on the debtor and the debtor's dependents." 11 U.S.C. §523(a)(8). In this case, the bankruptcy court found that Miller had not made a showing of undue hardship. Nevertheless, the court relied on 11 U.S.C. §105(a), which provides that a court "may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," to grant Miller a partial discharge of her student loan obligations.

PHEAA argues that a showing of undue hardship—as provided by §523(a)(8)—is the only means by which a court can discharge student loan indebtedness. According to PHEAA, since Miller has not made a showing of undue hardship, none of her educational loan debt is dischargeable. The central issues of this appeal are, therefore, whether a bankruptcy court can rely on §105(a) to grant a partial discharge of student loan indebtedness and whether, before a bankruptcy court grants such a discharge, it must first find that the portion being discharged satisfies the "undue hardship" requirement of 11 U.S.C. §523(a)(8).

Although the bankruptcy court found that Miller was not entitled to a complete discharge of her educational loans, the court utilized its §105(a) powers to partially discharge her student loans. This court has sanctioned such a procedure. See Hornsby v. Tenn. Student Assistance Corp. (In re Hornsby), 144 F.3d 433, 439-40 (6th Cir.1998). In Hornsby, we disagreed with the bankruptcy court's finding that Chapter 7 debtors had shown that repayment of the entire balance of their student loans would impose an undue hardship upon them. While we concluded that the debtors were not entitled to a full discharge of their student loans pursuant to §523(a)(8), we found that §105(a) empowered the bankruptcy court "to take action short of total discharge." Id. at 438-39. As will be explained below, we view Hornsby as authorizing the grant of a partial discharge of a debtor's student loans but only when certain requirements are met.

Our holding in Hornsby was that, "pursuant to its powers codified in §105(a), the bankruptcy court . . . may fashion a remedy allowing the Hornsby's ultimately to satisfy
their obligations to [their loan guarantor] while at the same time providing them some of the benefits that bankruptcy brings in the form of relief from oppressive financial circumstances." Id. at 440. ***

Hornsby also explained the need for taking action short of full discharge of a debtor's student loans in this way: "In a student-loan discharge case where undue hardship does not exist, but where facts and circumstances require intervention in the financial burden on the debtor, an all-or-nothing treatment thwarts the purpose of the Bankruptcy Act." Id. at 439.

We construe the language of these passages as providing guidance to bankruptcy courts in circumstances where granting a full discharge of student loan indebtedness is unwarranted because the debtor cannot show that excepting the entire balance of her student loans from discharge would impose undue hardship but where some form of relief seemed warranted—the precise factual conclusion reached about the Hornsby's. Therefore, when a debtor does not make a showing of undue hardship with respect to the entirety of her student loans, a bankruptcy court may—pursuant to its §105(a) powers—contemplate granting the various forms of relief discussed in Hornsby, including granting a partial discharge of the debtor's student loans. ***

The limiting condition placed on this discussion—"[w]here a debtor's circumstances do not constitute undue hardship as to part of the debt but repayment of the entire debt would be an undue hardship"—supports the notion that bankruptcy courts discharge the portion of student loan debt for which payment would impose an undue hardship on the debtor. For example, assume that a debtor owes $100,000 in student loans, and repayment of the full amount would impose undue hardship on the debtor but repayment of $40,000 would not. Hornsby indicates that a bankruptcy court would discharge $60,000 of the debt, the amount for which repayment would impose an undue hardship. The citations quoted by Hornsby also support the conclusion that undue hardship must be shown for the discharged amount. ***

We acknowledge that this understanding of Hornsby is at odds with the unpublished opinion of this court in DeMatteis v. Case Western Reserve University, a decision that we are not bound to follow. The court in DeMatteis rejected the conclusion of the bankruptcy appellate panel in that case that, in the context of discharging student loans, §105(a) acts as an "overlay on" §523(a)(8). Rather, the DeMatteis court reasoned that Hornsby should be read as advocating an "independent §105 equitable grounds theory."

This determination in DeMatteis suggests that the grant of a partial discharge of student loan indebtedness pursuant to §105(a) need not be made upon a showing of undue hardship with regard to the amount discharged. We cannot accept this conclusion. ***

While the undue hardship requirement applies to any discharge of student loan indebtedness, the bankruptcy code itself does not define "undue hardship." As a result, this court has looked to the test enunciated by the Second Circuit in Brunner v. New York State Higher Education Services Corp., 831 F.2d 395 (2d Cir.1987), to decide if a debtor has made the requisite showing of undue hardship. ***

This court, however, has not formally adopted the Brunner test and may look to other factors, including "the amount of the debt . . . [and] the rate at which interest is accruing" as well as "the debtor's claimed expenses and current standard of living, with a view toward ascertaining whether the debtor has attempted to minimize the expenses of himself and his dependents." Hornsby, 144 F.3d at 437 (quoting Rice, 78 F.3d at 1149) (first alteration in original). In addition, "the debtor's income, earning ability, health, educational background, dependents, age, accumulated wealth, and professional degree" may also be considered. Rice, 78 F.3d at 1149. Finally, a court may inquire into "whether
the debtor has attempted to maximize his income by seeking or obtaining stable employment commensurate with his educational background and abilities.” Id. at 1149-50.

In considering whether to discharge Miller's student loans, the bankruptcy court first analyzed whether Miller had shown by a preponderance of the evidence that she satisfied all three Brunner factors. The court found that Miller did not satisfy the second and third factors of the Brunner test. According to the bankruptcy court, Miller did not show that her financial situation was more than temporary because she is intelligent and well-spoken, albeit underemployed. The court also concluded that Miller had not satisfied Brunner's good faith prong because in the five years since she had left school, she had contributed only $368.00 towards repayment of her student loans, which totaled almost $90,000, while using such "non-essentials" as personal internet service, long distance telephone service, cell phone service, and cable television.

Despite not meeting the Brunner factors for undue hardship, the court relied on its "§105(a) powers" to partially discharge her student loans:

The Debtor, for the most part, leads a modest lifestyle. PHEAA's sought-after reduction of the Debtor's phone expenses and the total elimination of her cable and internet services would barely generate a third of the funds necessary to meet even the most basic loan consolidation schedule. Further, earnings from additional hours worked at the Debtor's second job are not a permanent solution to this dilemma. The court will not require the Debtor to work 56 hours per week for the next 25 years in order to repay her student loans. To do so would make her a slave to the loans and would deprive her of any future hope for financial independence. The court also cannot place total reliance on the funds freed up by the discharge of the Debtor's credit card bills. Those funds, while substantial, are partially offset by automobile payments and the inevitable maintenance and replacement costs associated with an older used car.

Consequently, when determining whether Miller's student loans should be partially discharged, the court did not apply the Brunner factors, or any other factors relied upon by this court in making a finding of undue hardship, but rather constructed its own framework for granting a partial discharge.

In so doing, the bankruptcy court impermissibly used its equitable authority. ***

III.

For the foregoing reasons, we reverse the decision of the district court affirming the order of the bankruptcy court and remand this case to the district court with instructions to remand to the bankruptcy court for proceedings consistent with this opinion.

Not all courts have accepted the idea that a partial discharge of student loans can be written into the Bankruptcy Code, but a Congress fervent in protecting creditors did not attack the Miller line of cases in the 2005 Amendments.

We conclude with a case that was decided under the old Act, rather than the Code, but it contains so many eternal truths that we could not resist offering it to a new generation of bankruptcy students.
In re MILBANK
1 B.R. 150 (Bankr. S.D.N.Y. 1979)

SCHWARTZBERG, Bankruptcy Judge.

Plaintiffs are father and daughter who seek a nondischargeable determination with respect to their claims against the bankrupt, who is the ex-son-in-law of plaintiff, Howard Schulman, and ex-husband of plaintiff, Ann C. Milbank. The essence of their complaints is that the bankrupt obtained money from the plaintiffs at a time when he was having an adulterous affair with his next door neighbor and that he thereafter ran off with her. Since both complaints are based upon the same allegations of fraud the following determination will cover both cases.

The parties appeared at the trial and submitted evidence resulting in the following Findings of Fact:

FINDINGS OF FACT

1. The bankrupt, Mark A. Milbank, filed his voluntary petition in bankruptcy with this court on October 13, 1978, and was thereupon adjudicated. He had been engaged in the business of designing and fabricating custom furniture in Port Chester, New York.

2. Plaintiff, Ann Milbank, was married to the bankrupt on August 20, 1966, and resides in Nassau County, New York. She has three children from this marriage.

3. Plaintiff, Howard Schulman, is the father of plaintiff Ann Milbank and is an attorney at law with offices in New York City. He is a member of the firm of Schulman & Abarbanel, attorneys for both plaintiffs with respect to these proceedings against the bankrupt.

4. During the Spring of 1977, plaintiff, Howard Schulman, learned from his daughter and his former son-in-law, the bankrupt, that their marital relationship was in trouble and that they were trying to put it together again. The bankrupt had moved out of his house and left his wife for a period of five months, commencing January, 1977.

5. In September, 1977, after the bankrupt returned to the marital home, he requested that the plaintiff, Howard Schulman, lend him the sum of $10,000 as a partial payment for the purchase of a building in Port Chester, New York where the bankrupt could conduct his custom-made furniture business. The plaintiff, Howard Schulman, then believed that the bankrupt's marital relationship with the plaintiff's daughter had stabilized; the bankrupt had talked about building another house for his family. Plaintiff, Howard Schulman, was given to understand that the acquisition of the Port Chester location would enable the bankrupt to obtain greater production and alleviate some of his business problems so that the bankrupt could spend more time with his wife and children.

6. Plaintiff, Howard Schulman, advised the bankrupt that the purchase of the Port Chester building was a bad business investment because of the unique nature of the building which impaired its resaleability. However, plaintiff, Howard Schulman, advised the bankrupt that he would make the loan in the interest of the family and his grandchildren. He advanced the money in the belief that the new business location would afford the bankrupt more time to spend with his family.

7. On September 27, 1977, plaintiff, Howard Schulman, paid to the seller's attorney as a down payment for the purchase of the building on behalf of the bankrupt the sum of $5,750. Thereafter, on November 15, 1977, plaintiff, Howard Schulman, advanced to the
bankrupt an additional $4,250 which was used by the bankrupt to enable him to acquire the building in the name of the bankrupt's wholly owned corporation.

8. In August, 1977, the bankrupt requested his then wife, the plaintiff, Ann Milbank to advance to him $5,000 for the purchase of a new Honda automobile to be used in connection with his business. Repayment was to be made from the funds received by the bankrupt in connection with a business project then pending. Plaintiff, Ann Milbank, said that the bankrupt requested this money as a showing of her faith in their marriage and in him.

9. The bank account from which the $5,000 was taken was in the name of the plaintiff, Ann Milbank. She had formerly been a school teacher. Her salary went into this account. They lived on the bankrupt's earnings, although the bank account had been placed in their joint names until December, 1977, when the plaintiff, Ann Milbank, caused it to be put back into her name alone.

10. On or about November 11, 1977, the plaintiff, Ann Milbank, withdrew $7,500 from her bank account which she advanced to the bankrupt at his request in connection with his acquisition of the building in Port Chester, New York.

11. During the period when the plaintiff, Howard Schulman, advanced $5,750 to the bankrupt in September, 1977, and $4,250 on November 15, 1977, and when the plaintiff, Ann Milbank, advanced $5,000 to the bankrupt in August, 1977, and $7,500 in November, 1977, the bankrupt admittedly maintained an adulterous relationship with the wife of his next door neighbor.

12. During this time the bankrupt and his neighbor's wife registered at various motels and admittedly engaged in sexual activities. In October, 1977, the bankrupt rented an apartment in Long Beach, New York where the consorting neighbor visited him and had sex.

13. In December, 1977, plaintiff, Ann Milbank, first learned of the bankrupt's extra-marital affair when the husband of the next door neighbor telephoned to inform her that the bankrupt was having an affair with the neighbor's wife.


15. On October 4, 1979, the New York State Supreme Court, Nassau County, entered a decision granting the plaintiff, Ann Milbank, a divorce based on adultery committed by the bankrupt and the neighbor's wife, with whom he is now living.

16. The bankrupt did not repay any portion of the funds borrowed from the plaintiffs, with the result that they seek to have their claims determined to be nondischargeable.

17. There was no proof that when the bankrupt borrowed the funds from the plaintiffs he did not intend to make repayment. Hence, the central issue is even if the bankrupt intended to repay the loans, did he obtain the money under false pretenses?

18. The bankrupt made the stability of his marriage an issue in August, 1977, when he advised his former wife, plaintiff Ann Milbank, that her response to his request for the $5,000 loan for his purchase of a Honda automobile would be a reflection of her faith in their marriage.

19. Similarly the bankrupt's request for loans from his then father-in-law, plaintiff Howard Schulman, and the bankrupt's former wife, plaintiff Ann Milbank, were predicated on a joint effort by the bankrupt and his former wife to attempt to make their previously troubled marriage work. The bankrupt caused plaintiff, Howard Schulman, to believe that the acquisition of the Port Chester building would enable him to spend more time with his family. The plaintiff, Ann Milbank, advanced the sum of $7,500 from her
bank account at the bankrupt's request as an expression of faith in their marriage. Thus, the stability of the bankrupt's marriage was a material fact in inducing the loans.

20. Although the bankrupt accepted the funds which the plaintiffs advanced in reliance upon a faithful attempt by the bankrupt and his then wife to repair their marital difficulties, the bankrupt was then unfaithful.

21. During the period when the bankrupt accepted the loans from his then wife and father-in-law he was having an affair with the wife of his next door neighbor. Indeed, the bankrupt even went so far as to rent an apartment in Long Beach, New York where he continued his extra-marital affair until he finally abandoned his wife in January, 1978. Obviously, if the plaintiffs had been aware of the bankrupt's conduct they would not have made the loans. Surely, the bankrupt was aware of the fact that he could only obtain these advances under the pretense that he was making an effort to strengthen his marriage.

22. The bankrupt therefore pretended to his then wife and father-in-law that he was making a good faith effort to stabilize his marriage, when in fact, he was rending it asunder. This false pretense was instrumental in obtaining the loans because the plaintiffs made the advances in reliance upon the bankrupt's express request for a display of faith, at a time when he was faithless.

DISCUSSION

It does not follow that every family loan made concurrently with the commission of adulterous acts can be characterized as having been obtained as a result of fraud in the bankruptcy sense. In this case the bankrupt and his then wife had experienced previous marital difficulties. The bankrupt became restless; he felt he was cut out for better things, notwithstanding his marriage of over ten years which resulted in three children, one of whom was adopted. In January of 1977, he abandoned his wife and family for approximately five months. The bankrupt thereafter returned to his marital home in the Spring of 1977, with the hope of stabilizing his marriage; both husband and wife consulted marriage counselors in this effort. They intended to make a good faith effort to strengthen their marriage.

The plaintiffs, who are the bankrupt's then wife and father-in-law, made loans to the bankrupt to enable him to purchase an automobile for his custom-made furniture business and a building in which the business was to be conducted. These loans were made in reliance upon the bankrupt's representations that he and his wife would make a good faith effort to strengthen their marriage. After the bankrupt returned to his marital home, and unbeknownst to the plaintiffs, from whom the bankrupt requested loans for his business, the bankrupt was then engaged in an extra-marital affair with the wife of his next door neighbor. This conduct was thereafter admitted by the bankrupt in the plaintiff, Ann Milbank's suit for a divorce on the ground of adultery. Hence, the loans were made in reliance upon the bankrupt's expressed representation that he and his then wife would make a good faith effort to strengthen their marriage, when in fact, the bankrupt's conduct was a sham; his extra-marital affair evidenced the bankrupt's false pretenses with respect to a display of marital stability.

It is not essential that the bankrupt's pretenses be expressed in words. A deliberately created falsehood is the same as a spoken falsehood.

Manifestly, the plaintiffs would not have made the loans in question had they known that the bankrupt was not only not working at keeping his marriage together, but that he was at that time engaged in an extra-marital relationship with his neighbor's wife, for
whom he later abandoned his wife and children. The stability of the bankrupt's marriage to the plaintiff, Ann Milbank, and her faith in him were factors expressed by the bankrupt in order to induce the original loan. Accordingly, the stability of the marriage was a condition upon which the plaintiffs relied to their detriment as a result of the bankrupt's false pretenses.

CONCLUSIONS OF LAW

1. The plaintiff, Ann Milbank, was induced by the bankrupt's false pretenses in August, 1977, to loan him $5,000 for his purchase of a Honda automobile.

2. The bankrupt's indebtedness to the plaintiff, Ann Milbank, for the $5,000 loan to purchase a Honda automobile was obtained by false pretenses within the meaning of §17a(2) [now §523(a)(2)] of the Bankruptcy Act and, therefore, is nondischargeable.

3. The plaintiff, Ann Milbank, was induced by the bankrupt's false pretenses in November, 1977, to loan him $7,500 for the purchase of a building in Port Chester, New York.

4. The bankrupt's indebtedness to the plaintiff, Ann Milbank, for the $7,500 loan to purchase the Port Chester building was obtained by false pretenses within the meaning of §17a(2) of the Bankruptcy Act and, therefore, is nondischargeable.

5. The plaintiff, Howard Schulman, was induced by the bankrupt's false pretenses in September and November, 1977, to loan him $10,000 for his purchase of a building in Port Chester, New York.

6. The bankrupt's indebtedness to the plaintiff, Howard Schulman, for the $10,000 loan to purchase the Port Chester building was obtained by false pretenses within the meaning of §17a(2) of the Bankruptcy Act and, therefore, is nondischargeable.

The entwining of moral and legal judgments has gotten too deep for us.

2. Tax Priorities and Discharge

The protected position for tax obligations raises important policy questions, while the nondischargeability of taxes sometimes has a powerful impact on other creditors and the post-bankruptcy situation of the debtor.

The kinds of taxes specified in section 507(a)(8)(A)-(G) are not only given priority in payment, but any unpaid portion of those taxes is exempted from discharge by section 523(a)(1)(A). In effect, the debtor is obligated to pay most income taxes and a raft of other taxes notwithstanding any declaration of bankruptcy. If the estate generates any money, the tax payment will receive a priority distribution. If the tax obligation remains, then the debtor will remain personally obligated after the bankruptcy until the taxes are paid in full.

Pre-petition interest on (a)(8) priority claims shares the priority of the claims themselves and enjoys their nondischargeable status. Collier on Bankruptcy ¶523.07[7]
Post-petition interest does not accrue on unsecured tax claims against the TIB and the property of the estate, §502(b), but post-petition interest does accrue against the debtor as to any unpaid, undischarged tax debts that survive the bankruptcy. Id.

Penalties on nondischargeable taxes are also nondischargeable, §523(a)(7), even though such penalties do not get priority in payment under section 507(a)(8). In other words, a penalty is dischargeable only if the related tax is dischargeable.

Not only are these tax debts nondischargeable, but the Internal Revenue Service has the right to satisfy them by seizing property that is otherwise exempt under state law. See United States v. Rodgers, 461 U.S. 677 (1983). No wonder most bankruptcy lawyers advise financially troubled clients to pay their taxes if nothing else.

The statute has many other wrinkles and twists, but these will suffice for now.

3. No Discharge, and Worse—Bankruptcy Crimes

In the basic course on bankruptcy there is insufficient time to deal with bankruptcy crimes. Nonetheless, it is important to note that the acts that trigger denial of discharge may also put the debtor in jeopardy for criminal sanctions. Concealment of assets, false oaths, false claims, fee fixing, and a number of other bankruptcy-specific actions are made crimes in 18 U.S.C. §§151-155.

No doubt most debtors who lose their discharge or their liberty (and perhaps some of those who do not) are the least appealing of those who use the legal system. Some of them are famous frauds who have victimized thousands of people. Yet sometimes a debtor reminds lawmakers that broadly written laws, in and out of bankruptcy, cast a wide net. The following story gives one more picture of the diversity of misfortunes that pass through the bankruptcy courts and are not successfully resolved there.

A Farmer, 70, Saw No Choice; Nor Did the Sentencing Judge

Pawnee City, Neb. — Ernest Krikava, wearing bib overalls caked with the dust of the Nebraska fields he was struggling to save after 50 years on the farm, would trudge past the hog pens and cringe at the frantic sound of his hungry pigs: a pained, high-pitched wail. It was the sound of starvation.

But there was no money for feed. The 70-year-old Mr. Krikava was behind on his loan payments, and the bank, which held a lien on his assets, including his hogs, was keeping the bulk of his income toward repayment of his debt of $240,000, releasing little to maintain his 1,000-acre farm.

In the spring of 1991, as some of the pigs began to die, Mr. Krikava became ever more desperate to buy feed. In a series of transactions, he sold about $35,000 worth of livestock under the name of his sister-in-law, a violation of his trust agreement with the bank. Later, when he sought protection from the bank in Federal bankruptcy court, he denied that any such sale had ever occurred.

Because of that lie, he was convicted of perjury at a 1993 trial and now sits in a minimum-security unit at the Federal prison in Leavenworth, Kan., where he is serving a five-month term. His case is one that critics of Federal mandatory sentencing say illustrates absurd consequences of stripping judges of much of their discretion when they mete out punishment.
In imposing sentence, Judge Warren K. Urbom of Federal District Court in Lincoln expressed reluctance to send Mr. Krikava to prison but noted that he had little choice: guidelines created by the United States Sentencing Commission, established by Congress in 1984 to bring consistency to haphazard Federal sentences, require a prison term of at least five months for a perjury conviction.

"I'm stuck with these guidelines," Judge Urbom said in an interview. "For a nonviolent offender, I'm not sure prison does much good."

Mr. Krikava's wife, Carol, and son, Kevin, pleaded guilty of perjury and received only probation, since the guidelines allow leniency for defendants who plead guilty. Mr. Krikava's not-guilty plea made him ineligible for any such consideration, a rule that civil libertarians say effectively punishes a defendant for exercising his right to trial. . . .

The imprisonment of Mr. Krikava (pronounced KRICK-uh-vuh), who reported to Leavenworth early in July to begin serving his sentence, has astonished his friends and neighbors here in this quiet countryside near the Kansas border. They talk in hushed tones of the family's devastation.

The Krikavas' farm was auctioned off in pieces. Carol Krikava, who stopped going to the doctor for a respiratory problem after the family's health insurance lapsed, died of that ailment in January. Kevin Krikava, 29, now works as a hired hand on another farm.

The family's lawyer, Bill Chapin, expresses outrage. "If they'd ripped off $35,000 and gone to the Cayman Islands, it would be different," he said. "But they used it to buy feed for hogs. I'm not saying they were right. But they were desperate. And something is wrong with our society when we can't see the larger picture here. This is a man who worked more than 50 years to build up the farm. Now he's lost his wife, lost his farm. But that isn't enough. He's got to go to prison. What was gained here?"

But Thomas J. Monaghan, the United States Attorney in Omaha, whose office prosecuted the perjury case, said Mr. Krikava had been justly convicted of a "serious white-collar crime," and noted that he could have been spared prison had he pleaded guilty.

"Even today, he hasn't accepted responsibility," Mr. Monaghan said. "If you're going to avail yourself of the bankruptcy courts, you have certain obligations. And one of them is to tell the truth. He didn't do that."

Mr. Krikava insists he did no wrong, given the circumstances.

"It was going to be a crime either way," he said in a telephone interview from prison. "It was a crime to sell those hogs out of trust, and it would have been a crime to let them starve."

He chafes at the notion that he could have avoided prison by pleading guilty. "I thought I had the right to go to a trial," he said bitterly.

His son still lives in the family's old farmhouse, on a nameless gravel road south of town. But now he pays rent to its new owner, a doctor in Lincoln, who has agreed to sell back a parcel of the land if the Krikavas can raise the money.

"We did do some wrong things," Kevin Krikava said. "We were scared, and we panicked." . . .

The family's lawyers say that the Krikavas' financial situation worsened after they obtained their $250,000 loan, for farm operations, in 1990, but that even then the farm's assets outweighed the debt. Later, though, Mr. Krikava was required to pay the legal fees that the bank incurred as a result of the bankruptcy hearings.

Mr. Chapin, the lawyer for Mr. Krikava, says these fees exceeded $60,000 and ate up much of the Krikavas' equity in the farm. And when Mr. Krikava was
convicted of perjury, the bankruptcy was moved from a Chapter 11 proceeding, which provides for the restructuring of debt, to Chapter 7, which calls for liquidation of assets.

Don Leuger, the president of the Community National Bank in Seneca, Kan., which held the lien on the Krikava farm, said the bank had given the family ample opportunity to renegotiate the loan.

"We tried to work with them," he said, "but they weren't satisfied."

But Mr. Krikava and his son say the bank ignored their warnings that hogs were dying for lack of feed. At times, Mr. Krikava says, he would simply open the gate to the hog pen and let the pigs graze on weeds, which would not fatten them but at least quelled the pangs of hunger for a time.

And things were not much better for the family than for the hogs. "For about a week, we didn't even have any food in the house," Kevin Krikava said. "We were literally surviving on popcorn and canned peaches for a while."

Before sentencing, Judge Urbom received dozens of letters that praised the character of the Krikava family. Herbert Klepper, a former hired hand for the family, wrote of Ernest Krikava's kindness and patience: "I hope that someday Ernie will get back on his feet and need a hired hand again, because I would give up my job to go back to work for him. He was like a father to me."

United States Representative Jim Slattery, Democrat of Kansas, has sent a letter to President Clinton asking him to consider clemency for Mr. Krikava.

"He simply found himself backed into a hole and did what he thought he had to do to survive financially," Mr. Slattery wrote.

On July 3, Kevin Krikava drove his father to Leavenworth, where the elder Mr. Krikava surrendered and began serving his sentence. Kevin said his father had never before spent more than two nights away from the farm.

Ernest Krikava said he planned to "start all over" in farming once he leaves prison. "It's all I know," he said.

The son has sent a letter to the President, six pages, handprinted. "Please help me," he wrote. "I think you are the only one who can."


The next crime scene ends this section with a very different kind of tale, that of a mendacious lawyer who discovers poetic justice.

UNITED STATES v. CLUCK
143F.3d 174(5thCir. 1998)

E. Grady JOLLY, Circuit Judge:

Elwood "Jack" Cluck appeals his conviction and sentence for committing bankruptcy fraud in violation of 18 U.S.C. §152(1) & (3). Finding no merit in any of Cluck's multitudinous and niggling points of error, we affirm. . . .

A
Before the events in this case, Cluck was an attorney who specialized, by his own admission, in the legal avoidance of income, estate, and gift taxes.¹ His practice was, by all accounts, quite successful, allowing Cluck to enjoy many of the finer things in life. In his case, the finer things ranged from an assortment of properties located throughout the state of Texas, to his own Beechcraft Bonanza airplane, to a collection of classic Jaguar automobiles.

Smooth travel sometimes comes to an abrupt halt, however, and so it was in the case of Cluck. In October 1989, the road ahead worsened considerably when a state court rendered judgment against him in the staggering amount of $2.9 million.² Although Cluck had high hopes that an appellate detour would shortly return him to his golden highway,³ he soon found that the detour itself would require a steep toll of 10 percent in the form of the supersedeas bond necessary to forestall execution. Short of funds and in need of a cul de sac in which to safely park his troubled vehicle for a while, Cluck turned to the refuge of the bankruptcy court, as many a similarly threatened sojourner had done before him.

Unlike these other voyagers, however, Cluck apparently concluded that his resources would need more protection than the bankruptcy court could provide until his appellate travels had reached their final destination. Thus, before invoking the power of Title 11, he perceived that it might be useful to keep some Jaguars in reserve, some money within easy access, and, maybe, just for good measure, a few of his favorite things beyond the reach of his creditors and the bankruptcy court. To this end, on March 26, 1990, Cluck returned a note for $50,000 to its grantor, Perfect Union Lodge. Perfect Union was one of Cluck's clients, and the note had been originally tendered in payment of certain legal services. Three days later, on March 29, Cluck pawned three Jaguars, a 1983 Chevrolet truck, his airplane, a Lone Star boat, and a Winnebago camper shell ("the Jaguars, etc.") to a used car dealer for $32,000,⁴ retaining for himself and his designee a right to reacquire at a set price⁵ within thirty to ninety days of the sale.

B

His affairs now in preliminary order, on March 30, Cluck filed his petition for Chapter 7 liquidation in the United States Bankruptcy Court for the Western District of Texas. As part of the standard Chapter 7 procedure, Cluck was required to file a Schedule of Assets and a Statement of Financial Affairs. These documents required, among other things, disclosure of all accounts receivable, rights of acquisition, and asset transfers during the prior year. On his forms, Cluck made no mention of the assets recently pawned to the used car dealer or of his right to reacquire. He also did not disclose his return of the $50,000 note or the corresponding account receivable from Perfect Union Lodge. In addition, Cluck failed to list a transfer of 351 acres of land in McMullen

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1. An undoubtedly satisfying profession that we do not disparage. See Estate of McLendon v. Commissioner of Internal Revenue, 135 F.3d 1017, 1025 n.16 (5th Cir. 1998).
2. The suit was based on alleged fraudulent conduct by Cluck in his handling of the estate of Booney M. Moore, one of his tax planning clients. It was brought pursuant to Texas's Deceptive Trade Practices Act, whose punitive damage provisions gave rise to the large award.
3. As well he should have. The judgment entered on the jury's verdict was reversed. . . .
4. A price that was, needless to say, significantly below the assets' fair market value.
5. About $38,000.
County, Texas, that he had made on June 21, 1989. Finally, and significantly for this appeal, Cluck also neglected to include a further $150,000 in pre-petition accounts receivable from another of his clients, the O. D. Dooley Estate.

On July 31, Cluck's bankruptcy came to its first purported close, and the bankruptcy court entered an order discharging him from all dischargeable debts. Thinking his plan to have succeeded, on November 9, Cluck collected $48,000 from the O. D. Dooley Estate in partial payment of that client's aforementioned pre-petition account receivable. On November 16, the remaining $102,000 followed. About seven months later, on June 28, 1991, Cluck collected $35,000 from Perfect Union in settlement of its still-outstanding $50,000 account receivable. Of these funds, a portion was deposited into the account of First Capitol Mortgage, a Nevada corporation owned by Cluck's wife, Kristine. By this time, First Capitol had also reacquired all of the assets that had been pawned to the used car dealer. As might be suspected, neither the receipt of the money nor the reacquisition of the assets was revealed to the bankruptcy trustee.

II

The bankruptcy court's finding of intentional concealment apparently aroused the interest of the U.S. Attorney, and on March 27, 1995, Cluck was charged with eight counts of bankruptcy fraud in violation of 18 U.S.C. §152(1) & (3). The counts were essentially as follows:

[False statements and fraudulent concealment].

On January 16, 1997, a jury found Cluck guilty on counts one, three, four, five, six, seven, and eight, and not guilty on count two. On May 22, 1997, Cluck was sentenced to concurrent terms of twenty-four months imprisonment on each count, and ordered to pay restitution in the amount of $185,000. Cluck appeals his conviction, sentence, and restitution order on multiple grounds.

C

Cluck next attempts to persuade us that the evidence was insufficient on all the counts of his indictment with respect to intent. Under §152(1) & (3), the prosecution must show that the concealment or false statement was made "knowingly and fraudulently." Cluck argues, essentially, that the evidence showed only that he was careless in providing information to his bankruptcy attorney, not that he committed intentional fraud.

. . . It is well established that "'[c]ircumstances altogether inconclusive, if separately considered, may, by their number and joint operation, especially when corroborated by moral coincidences, be sufficient to constitute conclusive proof.'" United States v. Ayala, 887 F.2d 62, 67 (5th Cir. 1989) (quoting The Slavers (Reindeer), 69 U.S. (2 Wall.) 383, 401, 17 L. Ed. 911 (1864)).

In this case, it is manifestly clear that Cluck's repeated omissions and history of coincidental and questionable transfers formed just the sort of "circumstances" that the Supreme Court had in mind in the Reindeer case. Based on our review of the record, we are convinced that a rational jury could have inferred the existence of an intentional plan to defraud from the bare facts of Cluck's systematic concealment and false statements. We therefore find no merit to his argument that the evidence was insufficient on this point.
Having found no merit in any of Cluck's numerous points of error, for the foregoing reasons, the judgment of the district court is AFFIRMED.

Denial of discharge is one form of discipline, and prison is another. While our consumer bankruptcy laws may fairly be characterized as generous to troubled debtors, it is important that debtors be fair with the system. The threat of jail is useful in keeping the system in balance. Unfortunately, not many U.S. attorneys are prepared to invest resources in this kind of prosecution. In the Cluck case, it may be that the spectacle of a fellow lawyer behaving as he did was enough to produce action.

**Problem Set 12**

12.1. Wallace Laymon has held a variety of jobs during the past ten years. He is restless and has some difficulty getting along with co-workers. He sometimes walks off jobs, gets fired, abruptly moves, or just "gets tired." Laymon's financial records are a complete disaster. He has no checking statements, no bill receipts, and no clear record of any of his financial dealings except a handful of bills and dunning notices that have arrived in the past two months. Does Laymon face any difficulties in bankruptcy? Should he? Was Laymon required by any law to keep better financial records? See §727.

12.2. Gordon Gram was in serious financial difficulty for several months before he sought your advice. During this time he gave a financial statement to his principal creditor, Dina Chapman, to persuade her to hold off on enforcing the judgment she had gotten against him. The statement falsely stated that he owned 1,000 shares of AT&T stock, which he promised he would deliver to Dina as security for the debt. In the meantime, he also conveyed his only significant asset, his ski chalet, to his daughter. When the stock was not forthcoming, Dina started searching for property to grab. She found out about the chalet deal and initiated execution on the judgment and a levy against the chalet, a collection suit, but before she could collect, Gram filed for Chapter 7. Aside from the question of whether Dina's judgment lien survives in bankruptcy, will Gram have any difficulty discharging the debts he owes to Dina or to his other unsecured creditors? Should he? See §§523, 727. If Dina has an option, under which provision should she file her objection?

12.3. Gerry and Beth were divorced in Iowa. The court order provided that Beth would have custody of the three children (ages four, nine, and ten), that Gerry would take the homestead and specified furnishings, and that Gerry would pay Beth $10,000 in a lump sum now from his separate assets, $2,500 per month for the next five years, then $1,000 per month for the next nine years, and then $200 per month after that time until Beth dies. The day after the divorce was final, Gerry declared a Chapter 7 bankruptcy. Beth's divorce lawyer called you to ask what Beth will get. Would your answer change if the parties lived in Texas, which now permits only a very limited
form of alimony? Would it matter whether Beth were a wealthy veterinarian with an active practice or a woman who had not completed high school and who only sporadically held a paying job? Would it matter whether Gerry were a wealthy veterinarian with an active practice or a man who had not completed high school and who only sporadically held a paying job? See §523(a)(5), (15).

12.4. Chickie Narduchi makes his living through "creative debt collection services." Chickie has been very successful, but recently he has encountered a series of financial reverses that have forced him into bankruptcy. Among Chickie's creditors is a tort claimant who owed money to one of Chickie's clients. The claimant has an $800,000 judgment against Chickie for breaking four of his fingers, a favorite kneecap, and his big toe. Will the judgment creditor be discharged in bankruptcy? (Keep in mind that you might later discover that Chickie secretly owns 5 percent of the Forbidden Pleasures Casino, so he is not without assets worth pursuing.) See §523(a).

12.5. Shortly after Reynaldo and Maria Lujan were married, they purchased a rambling old home advertised as a "handyman's special." With visions of creating a quaint and charming nest, they bought a home that sucked up virtually all their cash. During the next three years, they worked constantly on the house and added such decorator touches as replacing the septic tank and rewiring the entire second floor. During that time, they carried maximum amounts on their credit cards, using the cards to support purchases for their house and to meet as many personal needs as they could finance through extended credit. Four months ago Maria was laid off and Reynaldo's income could not support the house and all the credit cards. Unfortunately, during that time their reliance on credit cards increased rather than decreased, so that their cards now represent $16,000 in unsecured debt.

Reynaldo and Maria have filed for Chapter 7 bankruptcy and sold the house, which brought just enough to pay off all the mortgages and home improvement loans and leave them with a small amount of exempt cash. As their attorney, you have looked over their credit card charges, and you see purchases of wallpaper ($850), plane tickets ($1,200), and clothes from a nice men's store ($600) within the three months preceding the filing. The card issuers have filed exceptions to discharge. What will you do at the hearing? See §523(a).

12.6. Craig O'Connor is a struggling young law student who has coped with inadequate parking facilities near his law school by parking wherever he wanted to, thereby collecting 122 parking tickets over three years. If O'Connor declares bankruptcy, will the parking tickets be discharged? See §523(a).

12.7. Congresswoman Herring has heard from an irate constituent about the nondischargeability of student loans, and so the good Congresswoman has promised to investigate. She can surmise the reasons behind the nondischargeability policy, but she has read recently that student loans actually have a lower default rate than other consumer loans, and that there is no empirical evidence of widespread abuse. If what she has read can be supported in congressional testimony, should that persuade Congress to amend the section so that student loans are treated like all others?
G. THE DEBTOR'S POST-BANKRUPTCY POSITION: REAFFIRMATION

Discharge is a legal milestone in a bankruptcy case, but often it is merely the beginning of an elaborate end game in which disappointed creditors may retaliate and shrewd ones may maneuver. The most common consequence of this end game is that, despite the language of financial rebirth and fresh start that pervades the bankruptcy literature, post-bankruptcy debtors are not like new babies—low on assets and free from any debt. The financial status of post-bankruptcy debtors is often surprisingly tangled with some of the same debt that sank them the first time around.

The legal key to this post-bankruptcy game is section 524 of the Code. At the moment of an individual debtor's Chapter 7 discharge, the section 362 automatic stay dissolves, §362(c)(2)(C), and the section 524 discharge injunction slides into its place. §524(a). The two injunctions are the bookends of a Chapter 7 case. The discharge injunction forbids any attempt to collect a dischargeable debt. Like the automatic stay, it has potentially unlimited penalties and is enforced summarily by contempt. It provides a powerful incentive to creditors to permit the debtor a fresh start.

However—in bankruptcy law, there is always a "however"—subsection 524(c) goes on to give the discharged creditor an opening by way of seeking that the debtor "reaffirm" the soon-to-be-discharged debt. That section provides that the debt can become once again legally enforceable, notwithstanding the discharge, if the debtor signs a reaffirmation agreement subject to the procedures and terms specified in that subsection. Of course, a debtor can always repay a creditor voluntarily after bankruptcy, but a properly obtained reaffirmation agreement goes much further, reviving the debt and making the debt (and any future penalties and interest provided in the agreement) fully enforceable in a court of law. The procedures required in subsection 524(c) include a requirement that the agreement be filed with the court and that it contain a option for the debtor to rescind the agreement for a period of sixty days.

The 1898 Act said nothing about reaffirmations. This bounced the question of the enforceability of a promise to pay a debt discharged in bankruptcy back to the common law of contracts. The common law was quite clear: such debts would be enforced. The result, according to the 1973 Report of the Bankruptcy Commission, was that debtors were preyed upon by their most aggressive creditors and many left bankruptcy owing nearly as much as they did before they filed. The commission recommended a complete ban on reaffirmations, but under pressure from the industry Congress opted instead to permit reaffirmations under very limited and closely monitored conditions. The 1978 Code required that the bankruptcy court make an independent inquiry into whether a reaffirmation was in the "debtor's best interests." If it was, the court approved the reaffirmation; if it was not, the court denied it. The 1978 reform apparently reduced the number of reaffirmations. Although little hard data were available, various estimates, including the Brookings Study from the 1960s, suggested that about 70 percent of debtors were signing binding reaffirmations under the old Act. The data from As We Forgive indicate that reaffirmations had slipped to about one in five debtors in the early 1980s after the new bankruptcy laws were in effect.

The consumer credit industry was unhappy about losing access to this alternative payment opportunity, and it pressed for a change in the law. The 1984 Amendments to the Code dropped the requirement of bankruptcy court approval in all cases in which the debtor was represented by a lawyer. Instead, in order to create a legally enforced...
reaffirmation, the lawyer would need to certify that the reaffirmation was in the debtor's best interest and to file an affidavit to that effect. As the authors of an important empirical study of reaffirmation have noted, "The new reaffirmation routine placed debtors' attorneys in a difficult position. They were to be decision-makers for, rather than advisors to, their clients." Marianne B. Culhane and Michaela M. White, Debt After Discharge: An Empirical Study of Reaffirmation, 73 Am. Bankr. Inst. L. Rev. 709, 716 (1999) [hereinafter "Culhane and White, Reaffirmation"]. There is reason to think that reaffirmations have increased as a result, although they have not reached the levels observed prior to 1978.

The sweeping protection of the discharge injunction and the powerful exception provided by a well-wielded reaffirmation agreement interact in two distinct contexts, secured debt and unsecured debt. We will discuss reaffirmations under each heading. As the discussion evolves, we will encounter the three most important incentives the creditor can use to attract a debtor into a reaffirmation. The first incentive relates to secured debt. It is the creditor's agreement not to repossess collateral that the debtor wants to keep, often collateral such as a car or a home that is exempt from other creditors but vulnerable to the holder of a valid security interest or mortgage. The second and third incentives relate to unsecured debt. They are an offer of future credit and the threat of an objection to discharge.

1. Reaffirmation of Secured Debt

The first point worth noting is deceptively simple: Debts are discharged, but liens are not. §506(d). The discharged debtor has no personal liability on any debt, so unsecured debts are effectively vaporized. But a secured debt remains attached to its collateral and can be enforced against the collateral after bankruptcy, even though the debtor cannot be sued for any deficiency. The discharge injunction forbids only an attempt to collect a debt "as a personal liability" of the discharged debtor. Collection by seizure of collateral is not forbidden. If a Chapter 7 debtor has any secured debts, the statute on its face offers only two alternatives to avoid surrendering the collateral to the creditor: redeem the collateral or negotiate a reaffirmation agreement with the creditor. Emerging case law has created a third option, which we may call "ride-through" (also known as "retention").

The first alternative, redemption, requires the debtor to pay the creditor the full loan or the full value of the collateral in cash, whichever is less. §722. The second alternative, reaffirmation, requires a cooperative creditor willing to agree to let the debtor keep the collateral. The agreement may be informal, allowing the debtor to keep the collateral so long as the debtor continues to make satisfactory payments on the loan. Other creditors may demand that their debtors formally reaffirm their debts through the bankruptcy court. §524(c). The consequence of reaffirmation of a secured debt is that debtors sign a legally binding agreement to waive the discharge on a given debt, subjecting themselves once again to losing the collateral and being sued for a deficiency claim if the debt is not paid off according to the terms of the reaffirmation. Unlike a redemption, which a debtor can force on an unwilling creditor if the debtor has the cash to redeem, a debtor cannot force a reaffirmation on a creditor who wants to terminate any relationship with the debtor. The third alternative, ride-through, which requires only maintenance of the contractual payments, has been permitted only in
some federal circuits. In this section, we will consider each of the methods by which the debtors can keep the Maytag or the Ford, starting with reaffirmation.

The role that secured debt plays in the post-bankruptcy financial lives of debtors should not be underestimated. In *As We Forgive*, a study of 2,200 consumer debtors reported that more than three-quarters listed some secured debt in their bankruptcy filings, a figure that has remained about the same among our 2001 debtors. In 2001 about half of all the debtors in the sample were buying their own homes, reporting median home mortgages of about $82,000, a figure that was about 17 percent higher than the median mortgage for nonbankrupt homeowners during the same time period. In addition, 78 percent of the debtors had loans secured by their cars, their furniture, their appliances, and other personal property. Most debtors either made substantial repayments following bankruptcy, or they found another place to live, another way to get to work, and so on.

The importance of secured debt is emphasized by the findings of the Consumer Bankruptcy Project for cases originally filed in 1991 and 2001. On average, in 1991 and 2001 debtors owed secured debt equal to more than three-quarters of their total assets. While that does not mean that the debtors would lose all that property absent redemption or reaffirmation (many secured debts are undersecured and other property may be unencumbered), these data demonstrate the overwhelming importance of secured debt in the financial lives of bankruptcy debtors.

The following case illustrates the application of the current version of the reaffirmation provisions of the Code as applied to a secured debt. The case is interesting not only for what it says about the application of the law but also for how it illustrates the tension between the debtor and the creditor—what each wants, and how much leverage each has to get it.

**In re PENDLEBURY**


Richard S. stair, Jr., Judge.

The debtors in these four Chapter 7 cases each filed a motion requesting an order striking a provision in a proposed reaffirmation agreement with Leader Federal Savings and Loan Association (Leader Federal). The reaffirmation agreements at issue purport to make the respective debtors, individually or jointly, as the case may be, responsible for the payment of attorney's fees in the amount of $250.00. By the execution of reaffirmation agreements, the debtors desire to retain possession of mobile homes financed through Leader Federal. The debtors do not, however, acquiesce in Leader Federal's insistence that each reaffirmation agreement contain the provision requiring payment of a $250.00 attorney's fee.

The trustee in each case has abandoned the mobile home as a burdensome asset of the estate. The court has withheld granting the discharges of the respective debtors pending resolution of the issues raised by their motions.
The Bankruptcy Code sanctions two methods by which debtors may retain possession of secured property: redemption or reaffirmation. Redemption, authorized under 11 U.S.C.A. §722 (West 1979), permits the debtor to redeem tangible secured personal property from a lien securing a consumer debt upon a lump-sum payment to the creditor of the fair market value of the property or the amount of the claim, whichever is less.

Redemption may be voluntary where the debtor and secured creditor stipulate the redemption value of the secured property. Redemption can also be involuntary. Reaffirmation contemplates a voluntary post-petition agreement between the debtor and creditor. In discussing reaffirmation under §524(c), the Court of Appeals for the Sixth Circuit has stated:

Section 524(c) authorizes a Chapter 7 debtor to seek renegotiation of the terms of the security agreement with the creditor thereby creating an alternative method pursuant to which a debtor may attempt to retain possession of secured collateral. Such an alternative, obviously attractive to the debtor financially unable to redeem the secured collateral through a lump-sum payment, is the equitable complement to §722. Simply, a debtor incapable or unwilling to tender a lump-sum redemption and redeem the secured collateral for its fair market value may reaffirm with the creditor; contra wise, a debtor confronted with a creditor unwilling to execute a renegotiation may retain the secured collateral by redeeming it for its fair market value, which value may be substantially less than the contractual indebtedness. However, §524(c) facially contemplates that the creditor, for whatever reason, may reject any and all tendered reaffirmation offers; §524(c) envisions execution of an "agreement" which, by definition, is a voluntary undertaking. . . .

In re Bell, 700 F.2d at 1056 (citations omitted).4 . . .

Procedurally, debtors in the Northern and Northeastern Divisions of this district are required to file reaffirmation agreements with the clerk prior to expiration of the bar date fixed in the order for meeting of creditors for filing complaints objecting to discharge under 11 U.S.C.A. §727 (West 1979 & Supp. 1988). At the reaffirmation hearings held pursuant to §524(d), this court does not interject itself into the reaffirmation process other than is required under §524(c)(5) and (6) and (d). The court recognizes that debtors' attorneys are in the best position to evaluate the effect of reaffirmation on their clients. Clearly, an attorney by affixing his signature to the declaration or affidavit required by §524(c)(3) certifies that attorney's participation in

2. 11 U.S.C.A. §524(f) (West Supp. 1988) makes it clear that a debtor may voluntarily repay debts, secured and unsecured, even if a reaffirmation agreement is not obtained. However, voluntary post-petition payments do not reobligate a debtor on the original debt nor is a secured creditor, by accepting voluntary payments, deprived of its right to repossess the secured collateral upon termination of the automatic stay.

4. The Bell court considered §524(c) as enacted by the Bankruptcy Reform Act of 1978. As originally enacted, §524(c) required every reaffirmation agreement to be approved by the court. The Bankruptcy Amendments and Federal Judgeship Act of 1984 substantially revised the reaffirmation provisions of the 1978 Act. Chief among these revisions is the requirement of the attorney declaration and the removal of court approval except as to debtors filing pro se. Notwithstanding the 1984 Amendments, the principles enunciated in Bell remain applicable to §524(c) as presently enacted.
the reaffirmation process and the accuracy of the representations contained therein to the best of the attorney’s knowledge, information and belief.

Notwithstanding the relaxed provisions of §524(c) under the 1984 Amendments respecting court approval, this court would in no way countenance overreaching by a secured creditor. The court would not hesitate in appropriate circumstances to utilize its equitable powers and interject itself into the reaffirmation process. Such a situation should, however, never occur where a debtor is represented by counsel. Congress’ intent that the court rely upon the declaration and affidavit filed by counsel is made manifest under the 1984 Amendments by removal of the requirement of court approval except as to reaffirmation agreements entered into by pro se debtors. In practice, reaffirmation hearings presently serve no useful purpose except for debtors filing pro se. Attorneys are rightly charged with the responsibility for advising their clients during the reaffirmation process. As is noted in the legislative history to the present §524(c):

In all, the new section is designed to encourage the prompt execution and implementation of good faith reaffirmation agreements by eliminating the cumbersome and unnecessary prior approval procedures which inhibited debtors and creditors from consummating mutually acceptable debt retirement arrangements.


II

The debtors in the instant proceedings are asking the court to intervene in the negotiation of their respective reaffirmation agreements for the purpose of limiting the terms of those agreements. They argue, though incorrectly, that their original contracts executed with Leader Federal do not provide for attorney’s fees in these circumstances. Debtors fail to recognize that the reaffirmation process involves negotiation. Even if debtors were correct in their assertions respecting the lack of a clause providing for attorney’s fees in their original contracts, Leader Federal is nonetheless not prohibited from negotiating a provision for the payment of attorney’s fees in its reaffirmation agreements. Likewise, the debtors are not prohibited from endeavoring to negotiate reaffirmation agreements with terms differing from those contained in their original contracts.

Clearly, as in any negotiation process, give and take will be required. It appears to the court that, under circumstances involving reaffirmation, a debtor has considerable bargaining power. In the first place, the creditor must recognize that in the absence of

8. For example, it would appear that interest rates, term of payment, amount of installment payments, methods for curing an arrearage, and the total amount of indebtedness to be reaffirmed are all factors to be considered by the debtor during the negotiation process. The latter is of special importance. Surely debtors and their attorneys would not dispute the wisdom of endeavoring to negotiate a reaffirmation agreement to reduce the amount of prepetition indebtedness to a sum more commensurate with the value of the collateral which is to secure the reaffirmed debt.
reaffirmation its debt will be discharged leaving recourse against its collateral as its sole remedy. Secondly, the creditor must consider reaffirmation in terms of expenses associated with repossession and foreclosure. It must also consider the resale value of its collateral. Merchants and secured lenders are in business to make a profit. They recognize the impact of bankruptcy and realize the advantage of negotiating a reaffirmation agreement which maintains an existing security interest, retains personal liability on the debtor and continues an uninterrupted stream of payments. Foreclosing a security interest in property whose value is generally speculative would, in this court's opinion, be a creditor's least desirable option.

Debtors must also recognize that a secured creditor might well expect to recover attorney's fees for the trouble and expense it has encountered in protecting its secured interest during bankruptcy proceedings. This court over the years has had occasion to review a considerable number of reaffirmation agreements and is comfortable in stating that for the most part attorney's fees negotiated by secured parties and debtors are fair and reasonable.9 During the course of negotiating a reaffirmation agreement, a debtor's attorney may determine that attorney's fees requested by a secured party are not fair and reasonable and will impose an undue hardship on the debtor or a dependent. Under such circumstances, that attorney cannot in good faith execute the declaration or affidavit required by §524(c)(3).

The court is mindful that the mobile homes at issue in the instant proceedings probably constitute the residences of the respective debtors. This factor does not, however, change the reaffirmation process required under §524(c). Whether the debtors desire to retain possession of an automobile, household furnishings, mobile home, or other item of property, the statutory requirements involving reaffirmation remain constant. It behooves debtors and their attorneys to thoroughly consider and discuss the redemption and reaffirmation options available prior to filing a case under Chapter 7. Redemption is, of course, the most attractive alternative as the debtor can force the secured creditor to accept payment of the fair market cash value of its collateral or the amount of its claim, whichever is less. High dollar consumer items such as automobiles and mobile homes do not lend themselves to redemption which requires a lump-sum cash payment. This is not to say that redemption cannot be achieved through installment payments for it most certainly can: (1) if the debtor and creditor agree that the debtor may redeem by installments and the parties comply with the reaffirmation provisions of §524(c);10 (2) by the debtor's filing of a petition under Chapter 13 of title 11.

Chapter 13 is designed to provide a debtor a fresh start through rehabilitation. On the other hand, Chapter 7 provides a debtor a fresh start through liquidation. As reaffirmation envisions the retention of debt beyond discharge it is to some extent inconsistent with the fresh start provisions of Chapter 7. No doubt this factor influenced Congress to include the Miranda warning approach mandated by §524(c) as originally enacted under the Bankruptcy Code of 1978. The Congressional philosophy has not been abrogated by the 1984 Amendments. Its implementation has implicitly

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9. Many reaffirmation agreements do not contain provisions providing for payment of attorney’s fees associated with the debtor’s default or the preparation and execution of the reaffirmation agreement.

10. In which event the debtor has not redeemed the property pursuant to 11 U.S.C.A. §722 (West 1979), but has reaffirmed the debt pursuant to 11 U.S.C.A. §524(c) (West Supp. 1988).
been shifted to the debtor's attorney. In effect, the debtors now invite the court to join the reaffirmation process and dictate to Leader Federal what it can and cannot include in its agreements in order to make those agreements palatable to the debtors and their attorneys. Not only is such a procedure not sanctioned by §524(c), its implementation could, it appears, make the court the chief architect of all future reaffirmation agreements. If debtors were entitled to call upon the court to determine the propriety and amount of attorney's fees requested by secured creditors would they not also be entitled to call upon the court to determine appropriate interest rates, lengths of extensions of contract payment terms, default provisions, and other terms all of which are the proper subject of negotiation under §524(c).

III

The debtors' motions seeking to strike the attorney's fee provision of the four reaffirmation agreements at issue will be denied.

As Pendlebury demonstrates, reaffirmation is a free-market activity. The creditor may demand what it chooses in exchange for permitting the debtor to keep the collateral. Apparently creditors regularly demand reaffirmation of the entire debt (with or without accrued interest and penalties), regardless of the value of the collateral. If Joe Debtor agrees to pay $2,000 to keep a car worth $5,000, it is easy for his attorney to sign the best-interest affidavit, assuming Joe can make the payments. But if Joe's car is worth $5,000 and the outstanding loan is $7,500, the creditor will probably demand he agree to repay the entire $7,500, plus future interest. Is it in Joe's best interest to pay so much more than the car is worth?

The answer may turn in part on Joe's alternatives, discussed below, but it is obvious Joe would rather pay only $5,000 for a $5,000 car. That alternative may be available under section 722 of the Code, "Redemption." Under Article 9 of the UCC a debtor is allowed to redeem collateral after default by paying the full amount owed, including late charges and other costs. UCC Revised §9-623. Redemption is available only if the collateral is exempt property or has been abandoned by the trustee. The leverage created by permitting the creditor to demand more than the value of the collateral ($7,500 for a car worth $5,000 in the prior example) was too much for Congress to sanction in consumer bankruptcy cases, so section 722 of the Code provides that the debtor may keep the collateral by paying the amount of the allowed secured claim, the value of the collateral. In the previous example, the debtor could redeem the $5,000 car by paying $5,000 in cash, with the remaining $2,500 being treated as an unsecured and dischargeable claim, just as it would have been if the car had been repossessed and sold.

The rub in the real world is that the debtor does not have $5,000 cash. For most debtors, section 722 might as well base redemption on the debtor successfully running a three-minute mile. Perhaps the most practical possibility for a few debtors is a loan from a friend or relative, in which case the debtor emerges from bankruptcy still greatly encumbered by debt. In the past few years, a business aptly named 722 Redemption has popped up in some states, offering to lend money to debtors (at high interest rates) so that they can redeem their cars. The math is simple: any debtor who is better off with the terms offered by 722 Redemption now has at least one alternative to reaffirming with the
original creditor. As we will see, Chapter 13 is another possible method of keeping the car or the washing machine, but it may require substantial long-term payments that the debtor cannot make. Thus the statutory alternatives to reaffirmation are often unavailable or unattractive.

The case law had developed a controversial third alternative: ride-through. Ride-through means keeping the collateral by continuing to make the pre-bankruptcy payments, without redeeming or reaffirming. The effect is to permit the debtor to keep and use the car or the washing machine after a Chapter 7 bankruptcy, while discharging any personal liability on the debt. If the collateral is damaged or destroyed, the debtor can simply abandon it, without being legally responsible for any deficiency. On the other hand, if the debtor keeps paying, the creditor will be repaid in full notwithstanding the debtor’s bankruptcy and the fact that the collateral might not have satisfied the debt in full. Because the Bankruptcy Code made no specific reference to ride-through, the issue of whether a debtor could make such a move had reached the level of the courts of appeals, with a number of decisions each way.

It appears that Congress may have settled the argument as a matter of federal law in the 2005 Amendments. It does so in two separate provisions that clash with each other in detail. §§362(h); 521(a)(2), (6). The former section is the stronger of the two. It simply removes the collateral from the estate and lifts the stay unless the debtor complies with the command in section 521(a)(2) to state an intention to do one of three things and then to do them: surrender the property, reaffirm the contract with the secured party on that collateral, or redeem pursuant to section 722. Section 521(a)(6) is similar in overall intent, but has a savings clause for the debtor if the creditor demands more than the original terms. It remains to be seen, however, whether a state court would permit a creditor to foreclose or repossess property of a post-bankruptcy debtor if the debtor was making all payments on the contracts, particularly if the creditor accepted any of those post-petition payments. It seems that the very state-law collection issues that persuaded some courts that ride-through is permissible may survive the 2005 Amendments.

One point that has been missed in all the legal analysis of the retention issue is that de facto retention is in fact the most frequent way in which debtors and creditors deal with collateral following a Chapter 7 bankruptcy. The study reported in As We Forgive found hints that retention was widespread as to home mortgages and the Culhane and White study of reaffirmations suggests that retention is widely used across the board. In effect, debtors just keep up their payments and creditors just keep taking the money, preferring an uncertain income stream to a repossession and sale that would be guaranteed, in most cases, to produce a substantial loss.

The parties’ legal rights are important, no doubt, but it is also important to understand how the system actually functions most of the time.

2. Reaffirmation of Unsecured Debt

The secured creditor has an obvious advantage in negotiating a reaffirmation agreement because it can always threaten to take back the collateral. The unsecured creditor is in a much less advantageous legal position. There are few obvious reasons a debtor would want to reaffirm an unsecured debt. One might be gratitude (e.g., to a doctor) and another affection (e.g., to a friend), but Sears and Federated Stores will not find many such opportunities. The most obvious incentive that might benefit a merchant or lender would
be the debtor's desire to protect a co-debtor, agreeing to pay off the loan that Mom had cosigned, as the next case illustrates.

In re PAGLIA, Debtor.

BERNARD MARKOVITZ, Bankruptcy Judge.

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FACTS

Debtor was the sole principal of a business known as F & M Fabricators until it ceased operating some time in 1990.

On January 24, 1990, debtor borrowed the sum of $13,000.00 from First National Bank of Western Pennsylvania, defendant's predecessor, for use in his business. He executed and delivered that same day a promissory note in favor of First National in the amount of $13,000.00 plus interest. The total amount due under the note, which was payable in full by March 31, 1990, was $13,282.08.

Irene Paglia, debtor's mother, did not execute the promissory note but pledged her interest in an annuity to secure payment of debtor's obligation. She executed an assignment of her interest in the annuity to First National on January 24, 1990.

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Debtor filed a voluntary chapter 7 petition on September 19, 1991. First National was identified on the schedules as having an undisputed general unsecured claim in the amount of $12,544.97 for a "loan obtained on behalf of employer on January 24, 1990."

First National sent a letter to Irene Paglia on November 15, 1991, informing her that debtor had defaulted on the above promissory note and demanding payment from her in the amount of $13,484.63. It further demanded that she liquidate the annuity she had pledged as security for debtor's obligation and use the proceeds to satisfy debtor's unpaid obligation. Legal action was threatened if the matter was not fully resolved by November 29, 1991.

On January 10, 1992, before debtor had received a discharge in his ongoing bankruptcy case, debtor executed a second promissory note in favor of First National in the amount of $13,635.00 plus interest. The total amount due under the note, which was payable in 108 monthly installments beginning on February 1, 1992, was $21,134.52.

As security for this new obligation, Irene Paglia once again pledged her interest in the annuity on January 10, 1992, and executed another assignment of her interest in the annuity to First National.

Debtor received a discharge of all his pre-petition obligations on April 16, 1992. Included among the discharged obligations was the debt arising out of the promissory note debtor had executed on January 24, 1990. His bankruptcy case was closed on April 23, 1992.

Debtor continued making monthly payments due under the second promissory note until March of 1999. The amount of the payments, including interest, he made to First National during this period totaled $23,119.82. No further payments were made after March of 1999.
On May 20, 2002, more than ten years after he had executed the second promissory note, debtor commenced this adversary action against Sky Bank, successor to First National. The complaint alleges, among other things, that First National had violated the discharge injunction—found at §524(a)(2) of the Bankruptcy Code—as well as the automatic stay—found at §362(a)—when it coerced him to execute the second promissory note.

Almost five months later, on October 25, 2002, debtor brought a motion to reopen his closed bankruptcy case so the adversary action could be heard and decided in this court. The motion was granted on December 3, 2002.

DISCUSSION

With certain exceptions not relevant here, the discharge of a pre-petition debt owed by a debtor in bankruptcy does not affect the liability of any other entity or their property for that debt. 11 U.S.C. §524(e). Furthermore, a debtor is not prohibited from voluntarily repaying any debt. 11 U.S.C. §524(f).

Unless a specific debt is expressly excepted, a debtor in bankruptcy is relieved of personal liability for all pre-petition debts upon receiving a discharge. See *Johnson v. Home State Bank*, 501 U.S. 78, 82-83, 111 S.Ct. 2150, 2153, 115 L.Ed.2d 66 (1991). Where a creditor has a security interest in property, a discharge extinguishes only the personal liability of the debtor in bankruptcy. The right of a secured creditor to proceed in rem against the collateral survives the debtor's discharge. Id.

The purpose of §524(a) is to afford a debtor a "fresh start" by ensuring that a debtor will not be pressured in any way to repay a debt after it has been discharged.

Merely permitting a debtor to execute to execute a new note which makes the debtor personally liable for a discharged debt, Mickens concluded, suffices for there to be an "act to collect" for purposes of this provision of the Bankruptcy Code.

We take issue with this reasoning because it postulates what effectively amounts to a per se principle of law that a creditor violates §524(a)(2) merely by passively permitting a debtor to execute another note and thereby to become personally liable once again for a discharged debt. A creditor, in other words, violates §524(a)(2), without regard for how active or passive it was prior to debtor's execution of another note and without regard to whether it actively sought to collect the discharged debt. Such a per se principle drains the phrase "act to collect" of all content and effectively renders it vacuous. It is difficult, if not impossible, utilizing this principle to conceive of a situation in which a creditor that passively permits a debtor to become liable once again for a discharged debt has not violated §524(a)(2).

Turning to the case now before us, nothing in the evidence presented at trial suffices to warrant the inference that defendant undertook in any way to collect a soon-to-be discharged debt from debtor or that it even advised him that he had to execute the second note. To the contrary, the evidence indicates that, acting out of filial loyalty, defendant

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1. This is not to say that inactivity on the part of a creditor can never constitute an "act to collect." We can envision situations in which inactivity on a creditor's part could so qualify. It is only to say that inactivity on a creditor's part need not do so. Whether it does depends on the particular facts and circumstances present in a specific case and cannot be determined a priori.
himself took the initiative and volunteered to execute the second note so defendant would not take legal action against his mother's annuity. Defendant was not willing to let this happen.

The most that can be said of defendant is that it accepted debtor's offer to execute the second note. Standing alone, this is a far cry from concluding that it undertook or acted to collect the debt from debtor. Debtor's contention that defendant coerced him into executing the second note is without merit.

****

Were the second note debtor executed on January 10, 1992, a "reaffirmation agreement" for purposes of §§ 524(c) and (d) of the Bankruptcy Code, the note would not be enforceable due to the absence of compliance with the requirements set forth in these provisions. The second note, which was not filed with the court, did not advise debtor that he could rescind it within a specified period of time, and did not advise him that he did not have to execute it. See 11 U.S.C. §§ 524(c), (d).

The obligation arising under the second note unquestionably bore a relationship to the first. The second note, however, was not a reaffirmation for purposes of these provisions of the debt arising under the first note. Debtor instead incurred a different obligation in return for different consideration. As consideration for the first note, debtor received money from defendant. As consideration for the second note, defendant agreed to forgo its lawful right to take action against the annuity pledged by debtor's mother which secured repayment of the obligation arising under the first note.

While he did not actively pursue it trial, debtor asserted in his complaint that defendant's conduct also violated the automatic stay provision of the Bankruptcy Code as well as 15 U.S.C. §1691. Defendant violated neither of these provisions.

***

This assertion is without merit for reasons stated previously. The reasoning underlying our previous determination that defendant did not commit an "act to collect" for purposes of §524(a)(2) applies pari passu with respect to the same phrase for purposes of §362(a)(6). Defendant therefore did not violate the automatic stay by undertaking an act to collect a pre-petition claim against debtor when it threatened to take legal action against the annuity belonging to debtor's mother and then instead permitted debtor to execute the second promissory note as an alternative.

*****

One argument the court ignored rests on the fact that Chapter 13 has a special stay to protect co-debtors like Irene Paglia. §1301. Thus it can be argued that the absence of any such provision in Chapter 7 makes it unlikely Congress would disapprove of a “passive” reaffirmation like the one in Paglia in which the debtor wished to protect a co-debtor. The larger point is that the case demonstrates the tension between the strict restraint of creditors under both the automatic stay and the discharge injunction—to do absolutely nothing to collect a debt except as the court permits in advance—and Congress’s friendly attitude toward reaffirmations.

It may make sense to reaffirm a loan signed by a co-debtor, but Culhane and White found relatively few reaffirmations of cosigned debts. Instead, most reaffirmations are the product of creditors' judicious use of a stick or a carrot: a threat to object to discharge or an offer of future credit.
Next we explore a far more direct challenge to the rules regulating reaffirmation. It seems from the case reports that objections to discharge have risen greatly in recent years, primarily because large national retailers and other credit grantors have developed systematic national programs to object to discharge in search of reaffirmation agreements. There are also programs that contact debtors (often by-passing their lawyers) with letters that offer continued use of the creditor's credit card if the debtor will agree to continue paying the old debt. Several bankruptcy judges reacted to these developments by inserting themselves in various ways into the reaffirmation process, despite the statutory language assigning debtor protection to the debtors' lawyers through the affidavit process. Reacting to that development, and perhaps to the awkwardness of the statutory procedures required for reaffirmation under subsection 524(c), a surprising number of national firms decided to take a bolder path. In the case that follows, Sears was owed both secured and unsecured debts and used both the threat of repossession and the incentive of new credit, although it did not threaten the debtor's discharge.

In re LATANOWICH

Carol J. Kenner, Chief Judge . . .

The Debtor, Francis M. Latanowich, acting pro se, filed his petition under Chapter 7 of the Bankruptcy Code on December 7, 1995. In his bankruptcy schedules, he listed total assets of only $375 and unsecured debts totaling $12,805.20, all in the nature of consumer credit. This sum included an unsecured, nonpriority debt to Sears in the listed amount of $1,073.64 for consumer purchases. In his schedule of current income and expenditures, he disclosed that he was married and unemployed, that he received total monthly income of only $500, consisting entirely of Social Security disability benefits, and that he had monthly expenditures of $1,449. The Chapter 7 Trustee in the case reported that the estate had no assets to distribute.

On April 1, 1996, with no objection to discharge or to the dischargeability of any debt having been filed, the Court entered a discharge . . .

On November 14, 1996, the Debtor, again acting pro se, filed a motion (in the form of a letter) to reopen his case. In his motion, he states that when he filed his bankruptcy petition in December, 1995,

I took advice from a lawyer friend and he told me to keep some of my debts so I could start getting my credit back. I receive 518 dollars a month on social security for a disability I have. I have tried to meet the payment every month but it is keeping food off the table for my kids. I would like to know if you could reopen my case so I could get rid of all my debt forever.

Below, he listed four debts from which he sought relief, totaling approximately $12,000, including the previously-listed debt to Sears, which now he quantified at $1,330.58.

. . . Sears initiated contact with the Debtor by mailing him a letter, accompanied by a proposed reaffirmation agreement. The letter informed the Debtor that Sears had received notice of his bankruptcy filing and that his account balance was $1,161.34. It also informed him that Sears had a security interest in the merchandise represented in the account balance, including an automobile battery and a television set. It set forth the dates
of purchase for these items, their purchase prices, and their (then) current values as follows:

<table>
<thead>
<tr>
<th>Item</th>
<th>Date of Purchase</th>
<th>Purchase Price</th>
<th>Current Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Battery</td>
<td>7/17/95</td>
<td>$75.33</td>
<td>$75.33</td>
</tr>
<tr>
<td>Television</td>
<td>6/1/95</td>
<td>$503.87</td>
<td>$403.10</td>
</tr>
</tbody>
</table>

The letter then asked the Debtor to inform Sears of his intention as to his account. It listed three options:

A. Sign Reaffirmation Agreement as to account balance, to be paid in monthly installments.
B. Redeem merchandise, by making lump sum cash payment only.
C. Return merchandise to Sears.

The letter then stated that "should you elect to reaffirm for the account balance, a line of credit in the amount of $1,161.00 will be granted immediately to assist you in the establishment of a favorable credit history." . . .

On January 29, 1996, after receiving the letter, the Debtor called a representative of Sears, who informed the Debtor that unless he agreed to pay the full balance due, he would have to return the merchandise that was subject to Sears's security interest. When the Debtor indicated that he needed additional credit to purchase clothing for his children, the representative stated that if the Debtor did agree to reaffirm the debt, Sears would increase his credit limit to $200 above the amount then due. Believing he had no choice if he wanted to retain the merchandise, the Debtor indicated that he would sign the agreement. He also asked the representative whether Sears would notify the Court of the agreement. The representative answered, "All you have to do is sign the paper. We'll take care of the rest."

On January 29, 1996, the Debtor signed the reaffirmation agreement and returned it to Sears. Sears received the agreement but did not file it in the Debtor's bankruptcy case. This was not an oversight but a matter of policy on the part of Sears. Sears did not inform the Debtor that the agreement would not be binding unless submitted to the court. Nor did it inform him that it did not and would not file the agreement in the Bankruptcy Court.

After the Debtor called in February, 1996 to complain that his credit had not been restored, Sears did restore the Debtor's credit, though not in the full amount that had been promised. From March through November, 1996, the Debtor used this credit to purchase clothing, tools, and automotive services, all totaling $338.91. From March, 1996 through January of 1997, Sears billed the Debtor on a monthly basis, not only for the new debt but also for the prepetition debt, including postpetition interest thereon, which in itself averaged $21.50 per month during this period. . . .

Sears produced no witnesses or evidence of its own at the hearing. However, through its attorney, Mr. Harris, it explained that it did not file the reaffirmation agreement because, in another case in this district, Judge Hillman had entered an order of civil contempt under which Sears would incur sanctions if it filed further reaffirmation agreements containing certain prohibited language. . . .

[The court subsequently held that this reason was a "half truth" and that Sears's second reason for not filing was to avoid the constraints of section 524(c).]
At the close of the hearing, the Court took the matter under advisement and shortly thereafter issued two procedural orders. The first afforded interested parties an opportunity to file briefs in connection with the order to show cause. Sears filed a brief in defense of its actions, which it has now withdrawn; and the United States Trustee has filed a brief in support of sanctions.

***

On April 9, 1997, Sears withdrew the memorandum of law it had filed in response to the order to show cause and informed the Court that "the company no longer intends to contest the Court's order to show cause."

A discharge order operates as, among other things, an injunction against the commencement or continuation of any act to collect, recover, or offset any debt to which it applies—in this case, any prepetition debt—as a personal liability of the debtor, even if discharge of the debt was waived. 11 U.S.C. §524(a)(2).

The purpose of the permanent injunction set forth at §524(a)(2) and reiterated in the discharge order is to effectuate one of the primary purposes of the Bankruptcy Code: to afford the debtor a financial "fresh start." The Code permits debtors to reaffirm debts that would otherwise be discharged, but only under conditions, set forth in §524(c).

Section 524(c) provides that a reaffirmation agreement is enforceable only if certain requirements are met. Two are pertinent here: the agreement must be filed with the bankruptcy court, §524(c)(3); and, in instances where the debtor was not represented by counsel in the course of negotiating the agreement, the court must approve the agreement as (i) not imposing an undue hardship on the debtor or a dependent of the debtor and (ii) in the best interest of the debtor. §524(c)(6)(A). The first makes the second possible, and the second protects debtors from reaffirming debts improvidently—because they do not understand their rights and options, because they fall victim to overreaching creditors, or for whatever reason—by interposing the independent review and judgment of the court. These requirements are mandatory; and, as they exist to protect a debtor from his or her own bad judgment, the debtor cannot waive them.

****

For lack of filing and court approval, the agreement is void and never became effective or enforceable. Upon entry of the discharge order, the Debtor's prepetition obligation to Sears was discharged, and Sears was thereby enjoined from engaging in any act to collect it as a personal liability of the Debtor. Nonetheless, Sears did engage in acts to collect it as a personal liability of the Debtor.

Sears took these actions deliberately, with full knowledge that the agreement had not been filed and, consequently, that the debt was subject to the discharge injunction. Through Mr. Harris, Sears admitted that its failure to file the agreement was not inadvertent but deliberate.

Moreover, Sears's action in this case was no isolated incident. Sears admits that from January 1, 1995, through January 29, 1997, in over 2,700 cases in this district alone, it solicited and obtained a reaffirmation agreement that it then failed to file. That fact underscores Sears's willful and intentional flouting of the Bankruptcy Code.

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RELIEF, SANCTIONS, AND ENFORCEMENT MEASURES

a. Declaratory Relief and Compensatory Damages
The Debtor is entitled to a declaration that his prepetition debt to Sears is discharged, that the reaffirmation agreement is void and never became effective, that Sears remains enjoined from taking any action whatsoever to recover its claim as a personal liability of the Debtor, and that the balance owing on his Sears account as of November 13, 1996, was zero.

The Debtor is also entitled to compensation for his post-petition payments of principal and interest on the prepetition debt, a total of $375. . . .

The Debtor is also entitled to a reasonable sum, which I fix at $200, for his time and effort and for the travel and other incidental expenses he incurred in finally securing the benefit of his discharge. He would also be entitled to reasonable attorney's fees, but, fortunately for Sears, he was not represented by counsel in this matter. In sum, Sears shall pay the Debtor compensatory damages of $236.09, and it shall do so not by setoff and not in the form of an account credit or of a Sears gift certificate, but by cash.

b. Punitive Damages

The consequential damages in this case do not begin to reflect the magnitude of Sears's offense against Mr. Latanowich and against the bankruptcy law. Sears here made a conscious decision to disregard the clear requirements of the law because it was more expeditious and profitable to do so. 17 Its conduct toward the Debtor was predatory: Sears preyed on the Debtor when he was financially most vulnerable and powerless; and in doing so it deprived him of the fresh start that Congress intended that he should have. . . .

In this case, the consequential damages do little more than dispossess the contemnor of its ill-gotten gains, which leaves it in no worse a position than if it had not violated the law at all. This gives Sears no incentive to discontinue its unlawful practice. In the form of punitive damages, the Court will supply this incentive by making it significantly more costly for Sears to do business by illegal methods than by legal ones. . . . However, the Court will refrain from issuing an order of punitive damages today, since doing so might arguably impair the government's authority to impose criminal penalties. As soon as that issue is clarified, the Court will sanction Sears in an amount payable to Mr. Latanowich. . . .

c. Other Measures

The Court has issued an order to show cause why compensatory and punitive damages should not enter in each of the 2,733 other cases in which Sears has admitted that it obtained a reaffirmation from the debtor that it then failed to file.

Not surprisingly, the fallout from these events was extensive. Of particular interest to lawyers and law students was the fact that the Massachusetts court called in many of the lawyers involved in the Sears cases to find out why they had signed affidavits

17. The findings of fact on which the award of punitive damages have been established by proof beyond a reasonable doubt.
approving reaffirmations that were obviously not in the debtor's interest. In the course of some grilling from the bench, the court discovered that the lawyers often had failed to make the disclosures to the debtors required by the statute, even though in their affidavits they had sworn they had. The court joined an increasing number of courts in laying down detailed and rigorous standards for a lawyer to approve a reaffirmation. In addition, a recommended Reaffirmation Agreement has been adopted, Official Form 240B.

As for Sears, these revelations were naturally followed by civil and criminal investigations and class-action lawsuits. The final bill for its conduct was between $300 and $500 million dollars and an incalculable amount of bad press. Why would a major corporation take such a risk? Culhane and White, who have called the Sears-type procedures "rogue reaffirmations," provide the answer. With some important caveats, they estimate from their data that reaffirmations may represent $2.75 billion per year in potential recovery for creditors. Although Sears is only one creditor, because of its enormous size in the consumer market, Culhane and White estimate that Sears is involved in one-third of all the consumer bankruptcies filed in the United States each year. It had a lot to gain. But Sears was not alone. Federated Department Stores, G.E. Credit, and a number of other major companies had been engaged in similar activities, although on a smaller scale. Each consumer bankruptcy is a small event, except for the family involved, but consumer bankruptcy is a major component of the vast financial structure of consumer credit in America.

Perhaps in reaction to these cases or perhaps as a nod to debtor interests, the 2005 Amendments have inserted in section 524(c) an elaborate series of disclosures to debtors, reminiscent of the Truth In Lending Act disclosures. It seems unlikely that the addition of this boilerplate will have much effect, although it may help some consumers understand better what they will be required to do under a reaffirmation agreement and may force some to focus on their actual ability to make the payments they have promised. §524(c)(2), (k)(6)(A). Among the other weaknesses in these provisions, Congress gave creditors a safe harbor against any failure to abide by the rules by requiring only a good faith attempt to do so. §524(l)(3).

3. Debts to Sovereign States

The concept that bankruptcy is a universal proceeding, binding all creditors through Congress's plenary Article I power under the bankruptcy clause is subject to a major and growing exception: When the creditor is a state or local government, the federal courts have very limited powers of enforcement, whatever the theoretical rights of the parties might be under the Bankruptcy Code. If the debtor has stopped all the creditors except a state or local government, the scope of the debtor’s bankruptcy protection will be sharply narrowed.

The limitation grows out of a case far from bankruptcy law, a dispute between the State of Florida and the Seminole Tribe over an obligation imposed on the state by a federal gaming statute. Seminole Tribe of Florida v. Florida, 517 U.S. 44 (1996). The tribe sued the state, and the state defended on Eleventh Amendment grounds. As the majority and dissent in Seminole issued competing views of the scope of the Eleventh Amendment, the debate specifically included the effect on the bankruptcy laws, among others.
Following Seminole, the courts have engaged in a far-ranging effort to determine the boundaries of the opinion as it applies in bankruptcy. The two cases that follow reflect the general uncertainty surrounding the extent to which federal bankruptcy law can affect a state. The uncertainty is especially great and especially important as to the state's right to collect debts from a discharged debtor. Where will questions about discharge be resolved? Does the discharge injunction apply or must the debtors duke it out in state court? Many such questions are in active litigation. Because debts owed to states are involved in many consumer bankruptcy cases, the result may be to leave the debtors' fresh start very stale. As a result of Seminole, many debtors may leave bankruptcy only to head straight into state court to litigate the effects of their bankruptcy discharge, often with a state judiciary unfamiliar with the Code. Some debtors will find that before they can stabilize their economic circumstances, they must incur substantial additional expenses to finance substantial post-bankruptcy litigation.

TENNESSEE STUDENT ASSISTANCE CORPORATION, Petitioner, v. HOOD

Chief Justice REHNQUIST delivered the opinion of the Court.

Article I, § 8, cl. 4, of the Constitution provides that Congress shall have the power "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." We granted certiorari to determine whether this Clause grants Congress the authority to abrogate state sovereign immunity from private suits. Because we conclude that a proceeding initiated by a debtor to determine the dischargeability of a student loan debt is not a suit against the State for purposes of the Eleventh Amendment, we affirm the Court of Appeals' judgment, and we do not reach the question on which certiorari was granted.

I

Petitioner, Tennessee Student Assistance Corporation (TSAC), is a governmental corporation created by the Tennessee Legislature to administer student assistance programs. TSAC guarantees student loans made to residents of Tennessee and to nonresidents who are either enrolled in an eligible school in Tennessee or make loans through an approved Tennessee lender. §49-4-203.

Between July 1988 and February 1990, respondent, Pamela Hood, a resident of Tennessee, signed promissory notes for educational loans guaranteed by TSAC. In February 1999, Hood filed a "no asset" Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the Western District of Tennessee; at the time of the filing, her student loans had an outstanding balance of $4,169.31. TSAC did not participate in the proceeding, but Sallie Mae Service, Inc. (Sallie Mae), submitted a proof of claim to the Bankruptcy Court, which it subsequently assigned to TSAC. The Bankruptcy Court granted Hood a general discharge in June 1999. See 11 U.S.C. §727(a).

***

Hood filed a complaint against the United States of America, the Department of Education, and Sallie Mae . . . .
In response, TSAC filed a motion to dismiss the complaint for lack of jurisdiction, asserting Eleventh Amendment sovereign immunity.

II

By its terms, the Eleventh Amendment precludes suits "in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." For over a century, however, we have recognized that the States' sovereign immunity is not limited to the literal terms of the Eleventh Amendment.

States, nonetheless, may still be bound by some judicial actions without their consent. In *California v. Deep Sea Research, Inc.*, 523 U.S. 491, 118 S.Ct. 1464, 140 L.Ed.2d 626 (1998), we held that the Eleventh Amendment does not bar federal jurisdiction over *in rem* admiralty actions when the State is not in possession of the property. In that case, a private corporation located a historic shipwreck, the S.S. *Brother Jonathan*, in California's territorial waters. The corporation filed an *in rem* action in federal court seeking rights to the wreck and its cargo. The State of California intervened, arguing that it possessed title to the wreck and that its sovereign immunity precluded the court from adjudicating its rights. While acknowledging that the Eleventh Amendment might constrain federal courts' admiralty jurisdiction in some instances, we held that the States' sovereign immunity did not prohibit *in rem* admiralty actions in which the State did not possess the res, 523 U.S., at 507-508, 118 S.Ct. 1464.

The discharge of a debt by a bankruptcy court is similarly an *in rem* proceeding. Bankruptcy courts have exclusive jurisdiction over a debtor's property, wherever located, and over the estate. See 28 U.S.C. §1334(e). If a creditor chooses not to submit a proof of claim, once the debts are discharged, the creditor will be unable to collect on his unsecured loans. Rule 3002(a); see 11 U.S.C. §726. The discharge order releases a debtor from personal liability with respect to any discharged debt by voiding any past or future judgments on the debt and by operating as an injunction to prohibit creditors from attempting to collect or to recover the debt. §§ 524(a)(1), (2); 3 W. Norton, Bankruptcy Law and Practice 2d §48:1, p. 48-3 (1998) (hereinafter Norton).

A bankruptcy court is able to provide the debtor a fresh start in this manner, despite the lack of participation of all of his creditors, because the court's jurisdiction is premised on the debtor and his estate, and not on the creditors.

Under our longstanding precedent, States, whether or not they choose to participate in the proceeding, are bound by a bankruptcy court's discharge order no less than other creditors. At least when the bankruptcy court's jurisdiction over the res is unquestioned, cf. *United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S.Ct. 1011, 117 L.Ed.2d 181 (1992), our cases indicate that the exercise of its *in rem* jurisdiction to discharge a debt does not infringe state sovereignty.

TSAC concedes that States are generally bound by a bankruptcy court's discharge order, but argues that the particular process by which student loan debts are discharged unconstitutionally infringes its sovereignty. Student loans used to be presumptively discharged in a general discharge. But in 1976, Congress provided a significant benefit to the States by making it more difficult for debtors to discharge student loan debts.

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4. *Missouri v. Fiske*, 290 U.S. 18, 54 S.Ct. 18, 78 L.Ed. 145 (1933), is not to the contrary. There, we noted the State might still be bound by the federal court's adjudication even if an injunction could not issue. 290 U.S., at 29, 54 S.Ct. 18.
guaranteed by States. That benefit is currently governed by 11 U.S.C. §523(a)(8), which provides that student loan debts guaranteed by governmental units are not included in a general discharge order unless excepting the debt from the order would impose an "undue hardship" on the debtor. ***

No matter how difficult Congress has decided to make the discharge of student loan debt, the bankruptcy court's jurisdiction is premised on the res, not on the persona; that States were granted the presumptive benefit of nondischargeability does not alter the court's underlying authority. A debtor does not seek monetary damages or any affirmative relief from a State by seeking to discharge a debt; nor does he subject an unwilling State to a coercive judicial process. He seeks only a discharge of his debts. ***

We find no authority, in fine, that suggests a bankruptcy court's exercise of its in rem jurisdiction to discharge a student loan debt would infringe state sovereignty in the manner suggested by TSAC. We thus hold that the undue hardship determination sought by Hood in this case is not a suit against a State for purposes of the Eleventh Amendment.5

III

Lastly, we deal with the procedure that was used in this case. Creditors generally are not entitled to personal service before a bankruptcy court may discharge a debt. *** The current Bankruptcy Rules require the debtor to file an "adversary proceeding" against the State in order to discharge his student loan debt. The proceeding is considered part of the original bankruptcy case, see 10 Collier on Bankruptcy ¶7003.02 (15th ed. rev.2003), and still within the bankruptcy court's in rem jurisdiction as discussed above. But, as prescribed by the Rules, an "adversary proceeding" requires the service of a summons and a complaint. Rules 7001(6), 7003, and 7004.

Because this "adversary proceeding" has some similarities to a traditional civil trial, Justice THOMAS contends that the Bankruptcy Court cannot make an undue hardship determination without infringing TSAC's sovereignty ****

If Justice THOMAS' interpretation of Federal Maritime Comm'n were adopted, Deep Sea Research, Van Huffel, and Irving Trust, all of which involved proceedings resembling traditional civil adjudications, would likely have to be overruled. We are not willing to take such a step.

The issuance of process, nonetheless, is normally an indignity to the sovereignty of a State because its purpose is to establish personal jurisdiction over the State. We noted in Seminole Tribe, "The Eleventh Amendment does not exist solely in order to prevent federal-court judgments that must be paid out of a State's treasury; it also serves to avoid the indignity of subjecting a State to the coercive process of judicial tribunals at the instance of private parties." 517 U.S., at 58, 116 S.Ct. 1114 (citations and internal quotation marks omitted).

5. This is not to say, "a bankruptcy court's in rem jurisdiction overrides sovereign immunity," United States v. Nordic Village, Inc., 503 U.S. 30, 38, 112 S.Ct. 1011, 117 L.Ed.2d 181 (1992), as Justice THOMAS characterizes our opinion, post, at 1919, but rather that the court's exercise of its in rem jurisdiction to discharge a student loan debt is not an affront to the sovereignty of the State. Nor do we hold that every exercise of a bankruptcy court's in rem jurisdiction will not offend the sovereignty of the State. No such concerns are present here, and we do not address them.
Here, however, the Bankruptcy Court's in rem jurisdiction allows it to adjudicate the debtor's discharge claim without in personam jurisdiction over the State. See 4A C. Wright & A. Miller, Federal Practice and Procedure §1070, pp. 280-281 (3d ed.2002) (noting jurisdiction over the person is irrelevant if the court has jurisdiction over the property). Hood does not argue that the court should exercise personal jurisdiction; all she wants is a determination of the dischargeability of her debt. The text of §523(a)(8) does not require a summons, and absent Rule 7001(6) a debtor could proceed by motion, see Rule 9014 ("[I]n a contested matter . . . not otherwise governed by these rules, relief shall be requested by motion"), which would raise no constitutional concern. Hood concedes that even if TSAC ignores the summons and chooses not to participate in the proceeding the Bankruptcy Court cannot discharge her debt without making an undue hardship determination.

We see no reason why the service of a summons, which in this case is indistinguishable in practical effect from a motion, should be given dispositive weight. As we said in Idaho v. Coeur d'Alene Tribe of Idaho, 521 U.S. 261, 270 (1997), "[t]he real interests served by the Eleventh Amendment are not to be sacrificed to elementary mechanics of captions and pleading."

We therefore decline to decide whether a bankruptcy court's exercise of personal jurisdiction over a State would be valid under the Eleventh Amendment. *** The judgment of the United States Court of Appeals for the Sixth Circuit is affirmed, and the case is remanded for further proceedings consistent with this opinion.

Justice THOMAS, with whom Justice SCALIA joins, dissenting.

We granted certiorari in this case to decide whether Congress has the authority to abrogate state sovereign immunity under the Bankruptcy Clause. Instead of answering this question, the Court addresses a more difficult one regarding the extent to which a bankruptcy court's exercise of its in rem jurisdiction could offend the sovereignty of a creditor-State. I recognize that, as the Court concludes today, the in rem nature of bankruptcy proceedings might affect the ability of a debtor to obtain, by motion, a bankruptcy court determination that affects a creditor-State's rights, but I would not reach this difficult question here. Even if the Bankruptcy Court could have exercised its in rem jurisdiction to make an undue hardship determination by motion, I cannot ignore the fact that the determination in this case was sought pursuant to an adversary proceeding. Under Federal Maritime Comm'n v.  South Carolina Ports Authority, 535 U.S. 743, 122 S.Ct. 1864, 152 L.Ed.2d 962 (2002), the adversary proceeding here clearly constitutes a suit against the State for sovereign immunity purposes. I would thus reach the easier question presented and conclude that Congress lacks authority to abrogate state sovereign immunity under the Bankruptcy Clause.***

I

Although the adversary proceeding in this case does not require the State to "defend itself" against petitioner in the ordinary sense, the effect is the same, whether done by adversary proceeding or by motion, and whether the proceeding is in personam or in rem. In order to preserve its rights, the State is compelled either to subject itself to the Bankruptcy Court's jurisdiction or to forfeit its rights. And, whatever the nature of the Bankruptcy Court's jurisdiction, it maintains at least as much control over
nonconsenting States as the FMC, which lacks the power to enforce its own orders. *Federal Maritime Comm'n* rejected the view that the FMC's lack of enforcement power means that parties are not coerced to participate in its proceedings because the effect is the same—a State must submit to the adjudication or compromise its ability to defend itself in later proceedings. Here, if the State does not oppose the debtor's claim of undue hardship, the Bankruptcy Court is authorized to enter a default judgment *without making an undue hardship determination*. See Fed. Rules Bkrtcy. Proc. 7055, 9014 (adopting Fed. Rule Civ. Proc. 55 in both adversary proceedings and in contested matters governed by motion). The Court apparently concludes otherwise, but, tellingly, its only support for that questionable proposition is a statement made at oral argument.

As I explain in Part I-B, *infra*, I do not contest the assertion that in bankruptcy, like admiralty, there might be a limited *in rem* exception to state sovereign immunity from suit. Nor do I necessarily reject the argument that this proceeding could have been resolved by motion without offending the dignity of the State. However, because this case did not proceed by motion, I cannot resolve the merits based solely upon what might have, but did not, occur. I would therefore hold that the adversary proceeding in this case constituted a suit against the State for sovereign immunity purposes.

***

Subjecting the states to the discharge was the most important limitation the Court could impose on the *Seminole* doctrine as applied to bankruptcy, but many other effects remain. The thin distinction offered by the majority in *Hood* leaves open the possibility of a number of other areas in which an ordinary creditor would be stopped in its tracks, but a state government may violate the bankruptcy laws with impunity. So, for example, if a state or local government seizes a driver's license because the debtor failed to pay traffic tickets and offers to return the license if the debtor repays in full, that would seem to be a clear violation of the automatic stay, but it is not clear that the *Hood* majority would permit a bankruptcy court to issue an injunction that would require return of the license as opposed to the defensive use of the discharge in a lawsuit against the debtor. If not, then the protection offered by the bankruptcy laws has been significantly reduced. See *In re Raphael*, 238 B.R. 69 (D. N.J. 1999) for a pre-*Hood* discussion of these facts and a ruling that left the debtors to the mercy of the state courts.

The Supreme Court took an important step toward protecting bankruptcy jurisdiction in *Hood*, but the dance with state and local creditors is not yet over.

4. **Nondiscrimination**

Aside from creditors trying to avoid the effects of the discharge, discharged debtors seeking a fresh start also face the risk that employers or government agencies will look askance at someone who has been bankrupt and will refuse a job, a license, or a permit crucial to the debtor's livelihood or well-being. Conscious of that risk, Congress included in the Code section 525, which forbids discrimination of that sort. On the whole, however, the reported cases find the courts interpreting these provisions narrowly. It appears more debtors have lost such suits than have won them. Once again, the reported death of the stigma of bankruptcy seems a bit premature.
Problem Set 13

13.1. The Muscle Mart is the only complete bodybuilding gym in Missoula, Montana. It charges a monthly membership and adds assessments for use of the sauna and items ordered at the juice bar. MM has a firm policy (would they have flabby policies?): If two months of dues or sauna fees are left unpaid, the membership is revoked, and the former member is not permitted to use any of the equipment until the unpaid balance is paid in full.

Peter Lanier has just filed for a Chapter 7 bankruptcy, discharging among his other debts two months' worth of MM dues. MM has revoked Peter's membership, and Peter is frantic to get back to his workouts. He has offered to pay a month in advance, but MM refuses. What would you advise Peter? See §524(a).

13.2. Two months ago, you handled a routine Chapter 7 bankruptcy for Kevin James. Kevin is a gentle soul, and the bankruptcy has been bothering him. Last week, he was in a former creditor's store when a clerk made a remark about "stiffing your friends." Kevin said he felt terrible and offered to repay the debt. The store manager, an enterprising young man, got this promise in writing. Now Kevin fears this was not very smart. He is struggling with his current obligations and is not sure he can pay this creditor. He calls you to ask if that written agreement is enforceable. What do you tell him? See §524(c).

13.3. Chauncy "Big Moon" Mooney supports his wife and five children at a marginal level with his job as a dishwasher at a local bar. Big Moon lives for weekends, when he cruises with his old club, the Ramblers. Big Moon has the meanest machine in the club, a Fat Boy with Porker pipes and a Revteck high performance engine. Big Moon still owes $18,000 on the cycle; notwithstanding Big Moon's loving care, he wrecked it twice, so the cycle would appraise for about $15,000.

Because of ever-increasing costs of maintaining his family and cycle, Big Moon has been overwhelmed with unsecured debt and decides to declare bankruptcy. He has only one valuable asset—a very small home with a 4.5 percent mortgage. His equity in the home will yield about $16,000 after the costs of sale, all of which would be exempt. Monthly rent on an apartment will be more than double his present house payments. Big Moon proposes to sell the home and use the money to redeem his hog. Will you sign an "undue hardship" affidavit for Big Moon? See §722.

13.4. Tawanda Johnson is a single mother of two children who until recently has managed to keep the family in reasonable shape after her husband's death in a car-train accident. Her skills as a die etcher in the local microchip plant produced a decent income until a year ago, when the plant headed for somewhere in Asia. She held out for a technical job for quite a while, running up some substantial bills, but has been waiting tables and working a night-shift cleaning job the last four months to keep food on the table. Her big worry is holding on to her house and her car. The credit union has the mortgage. You've dealt with them before and know their policy: They'll happily agree to a reaff on the mortgage, but only if Tawanda also reaffs in full all her other debts to the credit union, which include three loans. Two are unsecured "signature" loans. The third is a car loan. The car is a four-year old Hyundai the couple bought used almost three years ago. It is worth $5,900 bluebook on which she owes $7,300. She is desperate to keep it, because it works pretty well (her husband was a mechanic and knew cars). If she had to buy a new one, "they could sell me trash and I wouldn't know it." Without a car, she couldn't get to either job. The house was
their dream home and Tawanda says she’d work three jobs to keep it. What do you advise her? What are you able and willing to do for her in this situation? §524(c).

13.5. You are about to file a routine Chapter 7 for the Perez couple, Juan and Sally. Juan drives a truck and Sally pilots an EMS ambulance. There is nothing special about the Chapter 7, except you notice a debt for state taxes from a few years ago. Although it seems clear the taxes are dischargeable under section 523, the state tax authority is very aggressive and you have heard of them going after debtors following bankruptcy, even though they never file claims in no-asset cases like that of the Perez family. What steps should you consider taking and why? What if your research shows that your state has recently adopted drivers-license suspension for failure to pay taxes?

13.6. You have just been hired by a medium-sized firm that has had little previous bankruptcy practice beyond representing creditor banks in a few actions. The partners have decided that in hiring you they are making a significant commitment to developing a bankruptcy practice. They have asked you for some suggestions on what will become the firm's policies regarding consumer bankruptcies, and today you have scheduled a presentation on reaffirmation. What will you propose should be the firm's practice on the attorney reaffirmation affidavit required in section 524(c)? Keep in mind during your presentation that the partners will be concerned about the number of attorney hours spent in relatively low-fee consumer cases, how consumer cases can be processed by lower-paid paralegals or new firm associates, and how to maintain good relations with all their clients.

13.7. Your firm represents Peoples State Bank, which does a substantial amount of consumer lending. With the rise in the number of consumer bankruptcies, PSB has decided it needs help in determining what to do when it holds a security interest in an automobile and the debtor declares bankruptcy. Because your firm has taken care of PSB's legal work for years, you know that PSB has a very protective lending agreement that includes a provision that the debtor's declaration of bankruptcy is an automatic default under the contract.

PSB brings its first case to you: The debtor, Jansen, has gone into bankruptcy owing PSB $7,899. The loan is at slightly better than average market rates. The loan is secured by a valid PMSI on a car worth $6,000. It would cost PSB about $500 to repossess and resell the car. Assuming average depreciation of the car and maintenance of the current payment schedule, if payments are continued the loan balance would decrease faster than the value of the car will decline. Jansen is not in default on the payments. He has a good job and says he plans to continue to pay on schedule.

PSB has three questions, two specific and one general: (1) can it get the car back in this situation, if it wants to; (2) if Jansen keeps the car, what portion of the amount owed will it get paid; and (3) what is your overall advice about how to handle this sort of problem? Keep in mind as you deal with PSB that they want you to develop some generalized principles that they can give to a loan officer so the loan officer can deal with bankrupt debtors without having to call you for expensive individualized analyses each time.

13.8. Carlos Valdez, the sales force supervisor from NCP Homebuilders, is back in your office today. He reminds you that it is his responsibility to monitor the work of the employees closely and to make certain that the sales representatives reflect the image of steadiness and integrity that NCP wishes to promote. Valdez tells you that he followed your advice and did not fire the employee whose wages were garnished (problem 5.3, Fourth Edition of Law of Debtors and Creditors), but he is certain that the employee's problems have gotten worse. The employee could not struggle along on
reduced take-home pay, and he has now filed for a Chapter 7 bankruptcy. Valdez has heard that agents in two other firms have mentioned "the kind of people NCP has," and he is apoplectic. Valdez is determined to fire him now. What is your advice? See §§524, 525.
CHAPTER 6
CHAPTER 13 BANKRUPTCY

A. ELEMENTS OF AN ACCEPTABLE PLAN

1. An Overview of Chapter 13

In the preceding chapters of this part, we have seen elements common to all consumer bankruptcies—enforcing the automatic stay and deciding what is property of the estate—and we have taken a consumer debtor through the steps of a Chapter 7 bankruptcy. The Bankruptcy Code provides an alternative for consumer debtors in financial trouble: a Chapter 13 Adjustment of Debt, or "Wage Earners' Plan" as it is often known.

The Chapter 13 option differs significantly from the Chapter 7 liquidation. In Chapter 7 debtors essentially freeze their assets and debts when they file for bankruptcy. Their assets become the property of the bankruptcy estate. The debtor keeps assets within the exemption limits and turns the excess over to the trustee for sale and distribution to the creditors. In return for liquidating all non-exempt assets, the debtor is relieved of any future obligations to pay dischargeable, pre-bankruptcy debts, and all the debtor's subsequent earnings are free from the reach of pre-petition creditors. The debtor either relinquishes property subject to a valid security interest or continues to make payments and keeps it.

By contrast, Chapter 13 focuses on using future earnings, rather than accumulated assets, to pay creditors. The debtor keeps all assets, regardless of whether the assets exceed exemption levels, but the debtor agrees to turn over a portion of all future income for a minimum of three years. The trustee takes a percentage of the debtor's income for each pay period, deducts a percentage to cover administrative expenses, and then distributes the remainder to the creditors according to a court-approved plan. When the debtor has completed the agreed payout, the debtor's remaining obligations are discharged.

As a result, every debtor who is eligible for both Chapter 7 and Chapter 13 must make a fundamental choice: To seek an immediate discharge in Chapter 7 or to try to pay some or all debts in installments under a Chapter 13 plan. The debtor who chooses Chapter 13 must prepare a plan detailing the amounts to be repaid and the terms of repayment in accord with certain statutory requirements. As we have seen, there are a number of provisions in Chapter 7, including section 707(b), that bar a debtor from that Chapter, leaving a choice of Chapter 13 or no bankruptcy relief at all.

From a creditor’s standpoint, the difference between Chapters 7 and 13 is the prospect of payment obtained by selling the debtor’s assets versus payment from the debtor’s future income. From the debtor’s viewpoint, the supervision of the court will last from the day of filing until plan payments are completed, generally three to five years. No discharge from debt will be granted until the debtor makes the very last
payment on the plan. This is a marked contrast to the Chapter 7 debtor who is generally under the jurisdiction of the court only from the filing to the day of the discharge hearing, which is usually held within six months. The timing of the Chapter 13 discharge also differs from Chapter 11, under which the approval of a plan generates an immediate discharge, even before the payments begin, unlike the delay in Chapter 13.

The Chapter 13 trustee has a somewhat different role from that of the Chapter 7 trustee. In Chapter 13 the debtor retains control of the property of the estate, although the statutory provisions are confused and have a number of gaps. §§1303, 1306. Thus the Chapter 13 TIB does not have the function of collecting, preserving, and selling the property of the estate. §1302(b)(1). Instead, the debtor remains in possession of the property.

Nonetheless, the Chapter 13 trustee has several important functions. The trustee is charged with objecting to improper creditor claims. The trustee is also responsible for ensuring that the debtor gives up the required amount of income, and the trustee asserts any objections to the debtor's discharge. At the same time the trustee has a duty to assist the debtor in the performance of the debtor's duties. §1302(b)(1), (4). In short, the trustee scrutinizes everyone connected with the case—debtor and creditors—to be sure they are following the rules set down in the Bankruptcy Code. The trustee's main duties, however, are in connection with confirmation of the plan and distribution of payments.

The trustee is generally expected to recommend approval or denial of confirmation of a debtor's plan. §1302(b)(2)(B). The trustee is obligated to ensure that payments are commenced within 30 days after the plan is filed and that the payments are properly distributed to creditors. §§1302(b)(5), 1326. Ordinarily, the plan provides that debtors will make a lump-sum monthly payment to the trustee and the trustee will then distribute the funds to the creditors, although some creditors may be paid directly (a procedure known as payment "outside the plan"). If the debtor's payments fall behind, it is usually the trustee who monitors the debtor's performance, urges compliance, and, if need be, files to dismiss the debtor's case for nonpayment. When a debtor misses a payment or two, trustees often seek wage attachment orders, which are routinely granted, so that a portion of the debtor's wages goes directly to the trustee for plan payments. Because the attachment is made pursuant to federal bankruptcy law, state restrictions on wage garnishment are inapplicable.

Most urban districts have "standing" Chapter 13 trustees who serve in a large number of cases. Some districts have more than one standing trustee because of the volume of business. 28 U.S.C. §586(b). The trustees are appointed by the United States Trustee. §1302(a); 28 U.S.C. §586(b). In more populous districts, many millions of dollars are distributed to creditors through the standing Chapter 13 trustees each year. In those districts, the position of standing trustee is not just a full-time job, but an active business relying on a highly sophisticated, computerized system of receipts and disbursements. The fees of standing trustees are fixed by the court, subject to statutory maximums. 28 U.S.C. §586(e).

If a trustee's office is often an active small business, Chapter 13 nationwide is Big Business, as the following report demonstrates.
Uncle Sam Is My Collection Agent
Forbes Magazine, June 15, 1998
By Brigid McMenamin

Last year 400,000 Americans filed for Chapter 13 personal bankruptcy, nearly three times the number a decade ago. Bad news? Not for Bear Stearns Cos. While banks and credit card firms grumble about deadbeats, those clever folks at the $3.5 billion . . . New York City–based investment bank and securities firm have found a way to cash in on them.

Bear Stearns is snapping up Chapter 13 debts of individuals, through . . . Max Recovery. Max pays creditors like Chase or Household Finance 8 cents to 15 cents on the dollar for claims against individuals going through a Chapter 13 bankruptcy. . . .

When the debtor starts sending monthly checks to the trustee under his payback plan, Bear Stearns gets the creditor's share, typically 20 cents to 70 cents on the dollar, sometimes more. Many debtors, however, never complete their payment plan. . . .

The key to this business is volume. The market is big: The combined unsecured debts of Chapter 13 filings come to some $6 billion a year. . . . It's just the latest example of the growing multibillion dollar trade in personal debt, from car loans and credit card balances to tort judgments and time shares. . . .

Creditors who opt to sell their claims simply don't think they'll net as much as Max Recovery can pay. . . . Union Bank of California, for one, sold $3 million of Chapter 13 accounts last year to Max Recovery. Bank officials figured they'd never beat 10 cents on the dollar.

What are the sellers thinking? "I don't think they [creditors] fully understand the value of what they're selling," says Jack Dennison [a seller of software to Chapter 13 trustees]. . . .

The business promises to grow, as legislation pending in Congress would force more consumers to choose Chapter 13 and pay off a bigger percentage of their debt. The politicians see some kind of moral imperative here. Bankers just see good business.

We will return to the financial and policy questions surrounding Chapter 13, but first we focus on how it works, starting with the required elements of a Chapter 13 plan, followed by a discussion of the eligibility requirements for declaring Chapter 13 bankruptcy. The consumer bankruptcy part concludes with a section exploring why a debtor might choose a Chapter 13 plan or feel forced to do so. At that point, we will have reviewed the details of most of the consumer bankruptcy options, and it will be possible to begin to develop an idea of what choices debtors realistically have and what factors might guide those choices.

Because the process of a Chapter 13 payout is very different from that of a Chapter 7 liquidation, we begin with a sketch of how the Chapter 13 case is filed and how the plan is proposed and confirmed.

A typical case is In re Foster, 670 F.2d 478, 482-483 (5th Cir. 1982). The court described how the Fosters initiated their Chapter 13 case:

On November 26, 1980, John W. Foster, Jr. and Myrtha D. Foster filed a petition and plan in bankruptcy pursuant to Chapter 13 of the United States Bankruptcy Code. According to the plan, the Fosters would pay to the bankruptcy trustee $350 per month for thirty-six months, which payments were to be used to pay 100 percent of the priority claim of the Internal Revenue Service, the full value of the collateral of all secured creditors whose claims were timely filed and duly proven and allowed (with the
exception of the mortgage claims separately provided for), and 49 percent on the claims of the unsecured creditors whose claims were duly proven and allowed. . . .

A Chapter 13 case is commenced by the filing of a Chapter 13 petition. §301. Only the debtor may commence a Chapter 13 proceeding; there is no provision for an "involuntary" Chapter 13. The commencement of the case creates an estate which includes, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case," §541, and property and earnings acquired after commencement of the case but before the case is closed, dismissed or converted, §1306(a), with the debtor remaining in possession of the property of the estate, except as provided in the confirmed plan or the order confirming the plan, §1306(b). The confirmation of a plan vests all of the property of the estate in the debtor. §1327(b). From the time of the filing of the Chapter 13 petition, the "automatic stay" provisions of §362 restrict the actions of creditors against the property of the estate or of the debtor, "prohibiting most acts and the commencement or continuation of most civil actions to collect a consumer debt." Again, a major concern is the protection of both debtor and creditor. Besides being a fundamental debtor protection, the stay provisions prevent some creditors from obtaining payment in preference to and to the detriment of other creditors. The automatic stay provisions remain in effect as concerns most acts until the case is closed or dismissed or a Chapter 13 discharge is granted or denied. §362(c). In addition to filing a petition, the debtor files a plan providing for the repayment of all or a portion of the claims against the debtor out of the debtor's future income (or out of the estate).

The key hurdle for the debtor is the development of an acceptable Chapter 13 plan. The plan is essentially the price the debtor agrees to pay for the protection of Chapter 13, and it is the debtor's responsibility to develop a plan that conforms to the statutory requirements.

The Fosters then began the process of having their plan confirmed by the bankruptcy court:

A creditors' meeting was held on February 11, 1981, at which the Fosters appeared and submitted to examination. Also in attendance were the bankruptcy trustee, appointed by the bankruptcy court, and the Fosters' attorney. The trustee recommended that a confirmation hearing be held and that the Chapter 13 plan proposed by the Fosters be confirmed.

At the confirmation hearing, held on February 26, 1981, the bankruptcy court noted that the Fosters' plan "met all requirements for confirmation and was recommended for confirmation by the trustee." . . .

Id. at 482. The Fosters' plan was ultimately approved by the court, although with some modifications.

The debtor's attempt to formulate an acceptable plan — and the legal hurdles the debtor encounters — is the subject of the several sections of this chapter. The Code provisions that tell us what may or must be in a Chapter 13 plan are somewhat arbitrarily distributed between sections 1322 and 1325. Section 1322(a)(2) gives the debtor the power to use a plan to modify the rights of creditors, both secured and unsecured. This power includes, for example, reduction of the amount to be paid and stretching out the period of time over which payment is to be made. Other provisions in the two sections then substantially constrain the debtor's power, especially with regard to secured creditors. These two sections will be our primary focus in the next portion of this chapter.
2. Payments to Secured Creditors

One of the most common reasons for choosing a Chapter 13 bankruptcy is the debtor's desire to keep property that is subject to a security interest. When a significant asset, such as a car or furniture, is subject to a valid security interest, the Chapter 13 plan is often built around satisfying the legal requirements for retaining that property and structuring a new payment schedule.

Just as secured creditors in Chapter 7 enjoy enhanced status and are entitled to greater repayment than unsecured creditors, the secured creditor in Chapter 13 enjoys substantially better protection than the unsecured creditor. The debtor's attempts to fashion a Chapter 13 plan to retain property subject to a security interest will often provoke a dispute with the secured party who declares the debtor in default and wants the collateral back. Whether the creditor can exercise its right to repossession and sale, realizing the value of the collateral and terminating its contract with the debtor, will depend on whether the debtor can comply with the provisions of Chapter 13 that are designed to protect secured creditors.

Courts must solve two separate but related issues when a secured creditor wants to repossess and sell the collateral. The first issue is protection of the secured party's interest in the collateral while the case is going on. Because the debtor proposes to keep the property, the secured party is naturally concerned about the risk that the collateral will lose its value. If the debtor defaults later on, the secured party could be left with collateral worth considerably less than when bankruptcy was originally filed. This problem is usually cast in terms of providing "adequate protection" for the secured party under section 362(d). The two principal types of risks that concern the secured creditor are a loss of the collateral (e.g., by fire, theft, or simple neglect) and a decline in its value (such as depreciation over time).

The second issue is adequate payment to the secured party. There is a statutory formula, discussed below, that calculates the minimum amount the debtor must pay in order to keep the collateral.

In Chapter 11 business cases the two issues are fairly distinct, with the first (adequate protection) focusing on immediate payments even while the plan negotiations are proceeding and the second (total payments) ensuring that the long-term payments will compensate the secured creditor to the extent of its legal protection in bankruptcy. Chapter 11 plans are often proposed months after filing, so that the first issue must be dealt with instantly while the second can await plan negotiations. In a Chapter 13, by contrast, the debtor's plan is usually filed with the bankruptcy petition and the two issues are often considered together. The next case and the text that follows it discuss the adequate protection problem. The two cases that follow after that discuss the payment requirement. In Radden the creditor sought to lift the automatic stay, and the court's focus is on adequate protection. In Rash and Hollins, the creditor objected to the provisions of the debtor's plan, and the court addresses the total payment problem.

As we noted at the beginning of the section on bankruptcy, when a debtor files for bankruptcy all collection attempts against the debtor—including repossession of collateral—are automatically stayed under section 362(a). A creditor can, however, move to have the automatic stay lifted under section 362(d), claiming that its interest in the collateral is not adequately protected. The creditor could move to lift the stay in any proceeding — Chapter 7, 13, or 11. In Chapter 7, because the parties are moving toward immediate liquidation, adequate protection is rarely argued. The debtor is
usually about to surrender the property to the creditor or to keep it via redemption, reaffirmation, or ride-through as we discussed in the materials on Chapter 7. A reaffirmation, redemption, or ride-through makes an adequate protection motion unnecessary or unavailable in Chapter 7. In Chapter 13 or Chapter 11, by contrast, the debtor proposes to retain the collateral and pay over a long time, often on terms different from the original contract. Creditors may respond with a claim that the debtor has failed to protect the creditors' statutory rights.

In the following case, creditor GMAC had already repossessed the car before the bankruptcy filing, and it wanted to retain and sell the car to pay off its outstanding loan balance. With the automatic stay in place, GMAC could not proceed with a sale, so it moved to lift the stay, arguing the application of both subsection 362(d)(1) and (2). Because GMAC had possession of the car, the debtor had to make two arguments in his response: one against the lifting of the stay, to prevent GMAC from selling the car immediately, and the other for return of the car to the debtor. The second argument relied on section 542 of the Code, which requires "turnover" of property to the trustee. Because the debtor in this Chapter 13 case retains possession of the estate's property, the debtor has the right to use the trustee's power to recover property.

In re RADDEN

SHELLEY, Bankruptcy Judge.

These matters involve the proper disposition of a 1979 Ford Mustang automobile (the "property"). The debtor, along with Priscilla Coe, purchased the property from Hechler Chevrolet, Inc. ("Hechler") on October 17, 1981. The property was titled in the debtor's name alone. Hechler financed this purchase by a retail installment sales contract secured by the vehicle. This installment sales agreement was assigned to GMAC pursuant to its agreement with Hechler entered July 3, 1980.

The debtor failed to make the contractually required payments to GMAC for the month of June, 1983. This constituted the first default under the assigned installment sales contract. The debtor did not cure the default and also failed to make the required monthly payment in July, 1983. [Apparently GMAC lawfully repossessed the car prior to bankruptcy.] GMAC notified the debtor and the cobuyer, Priscilla Coe, of their right to redeem the property and of a proposed sale of the property on August 12, 1983, if they did not redeem the property prior thereto.

On August 10, 1983, the debtor filed for relief under Chapter 13 of the Bankruptcy Code. In his Chapter 13 plan the debtor lists the value of the property as $2,700.00 and the balance due on the contract as $4,400.30. The Chapter 13 plan proposes to pay, through the standing Chapter 13 trustee, GMAC in full to the extent of the value of the collateral plus interest thereon at the rate of 5 percent per annum in deferred monthly cash payments of $89.68 over a period of 36 months. To the extent that the amount on the contract exceeds the value of the collateral, the obligation owing to GMAC is treated as an unsecured claim. Under the plan, unsecured claims are to receive seventy cents on the dollar.

The debtor lives about a mile and a half from his place of employment and about three blocks from a food store. He has been able to get groceries without difficulty
since the time GMAC obtained possession of the property. He has gotten to and from work either by obtaining rides from friends, by using his mother's automobile, or by walking. The debtor testified that (1) he is presently working from 3:00 until 11:00 and that a friend with an automobile in the same apartment complex works the same shift; (2) that he has missed very little work in the past five years at Western Electric, except that on at least one occasion he was absent because of inability to get to work; (3) that when he must walk home he does so on a street that is busy with traffic, is not lighted, and does not have a sidewalk; (4) that he has not yet been required to walk home from work in cold weather; (5) that he seeks a turnover of the property to enable him to get to and from work; (6) that although the property is not presently insured by him for collision and liability, he would re-obtain insurance on the property; (7) that he has the present finances to procure such insurance; and (8) that he has presently a valid driver's license.

CONCLUSIONS OF LAW

. . . GMAC here seeks relief based both on the lack of adequate protection, id. §362(d)(1), and on the grounds that the debtor does not have any equity in the property and that such property is not necessary for the debtor's effective reorganization. Id. §362(d)(2).

As to the latter basis for obtaining relief from the stay, this Court needs to find only that the property is necessary for an effective reorganization to deny GMAC relief pursuant to §362(d)(2). The debtor admits in his Chapter 13 plan and his memorandum in support of his adversary proceeding and in opposition to GMAC's adversary proceeding that he lacks equity in the property. Therefore, if the property questioned here is not necessary for the debtor's effective reorganization, the creditor is entitled to relief from stay.

The debtor bears the burden of proving that the property is necessary for his effective reorganization. §362(g). This Court is satisfied that an automobile is necessary for an individual's effective reorganization in today's society. As the debtor testified, he needs the property to get to and from his place of employment. Moreover, individuals need transportation to obtain medical as well as other necessary services. Having found that the property is necessary for an effective reorganization, this Court will not grant GMAC relief from the stay pursuant to §362(d)(2).

As an alternate basis for obtaining relief from the stay, GMAC alleges that it has an interest in property that is not adequately protected. Lack of adequate protection is sufficient "cause" pursuant to §362(d)(1) for a court to grant a creditor relief from the automatic stay. The resolution of GMAC's claim in this regard turns on the issue of what is GMAC's "interest in property."

[The court discussed and rejected GMAC's theory that it must be protected against any loss under its "recourse" or repayment agreement with the car dealer. The court then discussed GMAC's interest in the car itself.]

The Court notes initially that the property in which GMAC has an interest is currently in GMAC's possession, therefore, GMAC is in the best position to protect its interest in the property from the likelihood of theft, vandalism, or destruction by natural cause.

Second, under the provisions of the debtor's plan, GMAC will retain their lien on the collateral and receive the amount of their allowed secured claim with interest and, therefore, its interest in property will be adequately protected if the plan is effectively
consummated. GMAC has not demonstrated that the debtor's chances of rehabilitation are remote. To the contrary, the debtor has established that he has a stable employment record and that he is capable of meeting the payments to the standing trustee under the plan. The debtor has a reasonable likelihood of having his plan confirmed and consummated and, therefore, GMAC will likely receive the allowed amount of their secured claim through deferred cash payments. Recognizing this likelihood, GMAC's interest in property is adequately protected under the Chapter 13 plan and, therefore, GMAC requires no relief from the automatic stay to protect said interest. . . .

Finally, this Court now addresses the issue of the debtor's turnover complaint. The debtor seeks to recover the property that was returned voluntarily to GMAC prior to the filing of bankruptcy. The debtor seeks this turnover pursuant to §542. . .

The debtor here has filed a petition pursuant to Chapter 13 of the Bankruptcy Code. Section 1303 provides the debtor with the rights and powers that a trustee would have under Chapter 7 or the debtor in possession would have under Chapter 11. Consequently the debtor is a proper party to seek turnover pursuant to §542(a) because the property that the debtor seeks to have turned over is property that he as debtor may use in the ordinary course of business. See §363.

Having found that the debtor is the proper party to bring a §542 turnover complaint, this Court notes the elements of §542 include (1) an entity has possession, custody, or control of property (2) that the debtor may use the property pursuant to §363 and (3) that the property has value or benefit to the estate. . . .

For the reasons discussed above, this Court should and will order that GMAC return possession of the property to the debtor. The Court will not, however, order such turnover without providing adequate protection to the creditor of his interest in the property. The debtor's "use of the vehicle pursuant to §363(b) will presumably cause the value of the vehicle to decline." In re Williams, 6 B.R. at 792. This Court is satisfied, however, that if the debtor (1) procures adequate insurance on the property at the time of recovering possession and (2) makes monthly payments under the contract with GMAC until the time that a plan is confirmed, GMAC's interest in the subject property will be adequately protected and, therefore, the requirements of §361 and [§362(d)] will be satisfied.

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Adequate Protection

For Mr. Radden, Chapter 13 became an extraordinarily powerful tool. He was able to restructure his loan payments (more on that in the next case) and to reclaim a car from a creditor that had lawfully repossessed it after default. Once Radden filed, GMAC could sell the car and realize the value of the collateral immediately only if it moved to lift the stay and the court granted the motion under section 362(d). Failing that, GMAC would be off down the path of the three- to five-year Chapter 13 payout.

GMAC lost on both section 362(d) arguments. The court rejected application of section 362(d)(2). It conceded that the debtor had no equity in the property, but it concluded that the property was necessary for an effective reorganization. The court's conclusion about the necessity of the car seemed a bit tongue in cheek, particularly since
Radden had indicated that he had had little difficulty getting to work and that he was within walking distance of shopping. Concluding that an item of collateral is necessary for an effective reorganization is always a bit attenuated in a consumer setting, but it will take on far more significance later in business cases when we return to this issue in the Chapter 11 materials.

In its second argument, GMAC argued that the stay should be lifted because its interest in the car was not adequately protected as required in section 362(d)(1). The debtor would have possession of the car if the stay were not lifted, and the possibility existed that the car would decline in value or even be destroyed. In this case, the court found that the debtor's payments and agreement to arrange for adequate insurance met these risks so that GMAC was adequately protected.

**Modifying the Secured Creditor's Contract**

For the secured creditor that loses its move to lift the automatic stay, the next battle will likely shape up over how much the creditor will be paid under the Chapter 13 plan. As we discussed in the Chapter 7 materials, a secured creditor is far better protected in bankruptcy than an unsecured creditor, and the differences between the secured creditor's and unsecured creditor's payments under the Chapter 13 plan reflect this distinction. Nonetheless, even a secured creditor may find that its contract with a debtor has been modified in bankruptcy.

The general rule about required payments to secured creditors is contained in section 1325(a)(5). There are two requirements: a secured creditor must be paid its allowed secured claim in full and it must be paid interest on that claim. For the moment, we put the question of interest to one side and focus on the amount of the principal debt that must be paid.

We discussed previously the calculation of an allowed secured claim (see pp. 111-12) and saw that an undersecured claim is bifurcated by section 506(a) to yield two claims: a secured claim equal to the value of the collateral and an unsecured claim for the remainder (at state law, this would have been called the “deficiency”). Under the general rule of section 1325(a)(5), often called the “cramdown” section, the debtor can promise to pay the allowed secured claim (that is, the value of the collateral) in full, while treating the unsecured portion of the debt like any other unsecured debt.

Suppose a debtor couple who two years before bankruptcy granted a security interest for a loan on their office equipment. At the time of filing, the loan was $10,000 but the collateral was worth only $5,000. Assuming they have promised to pay 50 percent of their unsecured debt, they will pay $5,000 (secured claim) plus $2,500 (unsecured claim) to the creditor with the security interest in the equipment. If the debtors in this example complete the plan, they will discharge the remaining debt. For $7,500 total, they can keep the equipment during and after bankruptcy.

This treatment of an undersecured claim is often called “cramdown,” because it can be imposed over the secured creditor’s objection. If the debtors fail to complete the plan, they will lose the benefits of cramdown. The debt will not be discharged and following bankruptcy the secured creditor will once again be able to enforce its security interest with regard to all the unpaid debt. §1325(a)(5)(B)(i). But if they make it through, the unsecured portion of the creditor’s lien will be partially discharged along with all other unpaid, unsecured debt.
This approach traditionally applied to every type of secured debt except home mortgages, which we discuss in more detail below. The 2005 Amendments added language at the end of section 1325(a) that may have exempted certain security interests from the cramdown rule, although the added language is inartful, to say the least. If so, then two types of security interests granted fairly recently before bankruptcy are exempt from cramdown. Instead of being stripped to the value of the collateral, they must be paid in full—plus interest. First, any security interest granted within the year before bankruptcy is exempt. If the secured creditor objects to the plan, a debtor who wants to keep the collateral must promise to pay the debt in full. Second, for one specially favored secured creditor—the holder of a purchase money security interest in a motor vehicle—the time period is rolled much further back, to exempt security interests granted within two and a half years (910 days) prior to the bankruptcy petition.

For any security interest to which the general rule applies, the key question is the value of the collateral because that number will determine the amount of the allowed secured claim that must be paid in full. In the following case the Supreme Court addressed this problem, which had split six circuits at least three ways, proving once again that this stuff is hard for everyone.

**ASSOCIATES COMMERCIAL CORP. v. RASH**

520 U.S. 953 (1997)

Justice GINSBURG delivered the opinion of the Court.*

We resolve in this case a dispute concerning the proper application of §506(a) of the Bankruptcy Code when a bankrupt debtor has exercised the "cram down" option for which Code §1325(a)(5)(B) provides. Specifically, when a debtor, over a secured creditor's objection, seeks to retain and use the creditor's collateral in a Chapter 13 plan, is the value of the collateral to be determined by (1) what the secured creditor could obtain through foreclosure sale of the property (the "foreclosure-value" standard); (2) what the debtor would have to pay for comparable property (the "replacement-value" standard); or (3) the midpoint between these two measurements? We hold that §506(a) directs application of the replacement-value standard.

I

In 1989, respondent Elray Rash purchased for $73,700 a Kenworth tractor truck for use in his freight-hauling business. Rash made a downpayment on the truck, agreed to pay the seller the remainder in 60 monthly installments, and pledged the truck as collateral on the unpaid balance. The seller assigned the loan, and its lien on the truck, to petitioner Associates Commercial Corporation (ACC).

In March 1992, Elray and Jean Rash filed a joint petition and a repayment plan under Chapter 13 of the Bankruptcy Code (Code), 11 U.S.C. §§1301-1330. At the time of the bankruptcy filing, the balance owed to ACC on the truck loan was $41,171. Because it held a valid lien on the truck, ACC was listed in the bankruptcy petition as a creditor holding a secured claim. Under the Code, ACC's claim for the balance owed on the truck

* Justice SCALIA joins all but footnote 4 of this opinion.
was secured only to the extent of the value of the collateral; its claim over and above the value of the truck was unsecured. See 11 U.S.C. §506(a).

To qualify for confirmation under Chapter 13, the Rashes' plan had to satisfy the requirements set forth in §1325(a) of the Code. The Rashes' treatment of ACC's secured claim, in particular, is governed by subsection (a)(5). Under this provision, a plan's proposed treatment of secured claims can be confirmed if one of three conditions is satisfied: the secured creditor accepts the plan, see 11 U.S.C. §1325(a)(5)(A); the debtor surrenders the property securing the claim to the creditor, see §1325(a)(5)(C); or the debtor invokes the so-called "cram down" power, see §1325(a)(5)(B). Under the cram down option, the debtor is permitted to keep the property over the objection of the creditor; the creditor retains the lien securing the claim, see §1325(a)(5)(B)(i), and the debtor is required to provide the creditor with payments, over the life of the plan, that will total the present value of the allowed secured claim, i.e., the present value of the collateral, see §1325(a)(5)(B)(ii). The value of the allowed secured claim is governed by §506(a) of the Code.

The Rashes' Chapter 13 plan invoked the cram down power. It proposed that the Rashes retain the truck for use in the freight-hauling business and pay ACC, over 58 months, an amount equal to the present value of the truck. That value, the Rashes' petition alleged, was $28,500. ACC objected to the plan and asked the Bankruptcy Court to lift the automatic stay so ACC could repossess the truck. ACC also filed a proof of claim alleging that its claim was fully secured in the amount of $41,171. The Rashes filed an objection to ACC's claim. The Bankruptcy Court held an evidentiary hearing to resolve the dispute over the truck's value. At the hearing, ACC and the Rashes urged different valuation benchmarks. ACC maintained that the proper valuation was the price the Rashes would have to pay to purchase a like vehicle, an amount ACC's expert estimated to be $41,000. The Rashes, however, maintained that the proper valuation was the net amount ACC would realize upon foreclosure and sale of the collateral, an amount their expert estimated to be $31,875. The Bankruptcy Court agreed with the Rashes and fixed the amount of ACC's secured claim at $31,875; that sum, the court found, was the net amount ACC would realize if it exercised its right to repossess and sell the truck. The Bankruptcy Court thereafter approved the plan, and the United States District Court for the Eastern District of Texas affirmed.

On rehearing en banc . . . the Fifth Circuit affirmed the District Court, holding that ACC's allowed secured claim was limited to $31,875, the net foreclosure value of the truck. In re Rash, 90 F.3d 1036 (1996).

In reaching its decision, the Fifth Circuit highlighted, first, a conflict it perceived between the method of valuation ACC advanced, and the law of Texas defining the rights of secured creditors. See id., at 1041-1042 (citing Tex. Bus. & Com. Code Ann. §§9.504(a), (c), 9.505 (1991)). In the Fifth Circuit's view, valuing collateral in a federal bankruptcy proceeding under a replacement-value standard — thereby setting an amount generally higher than what a secured creditor could realize pursuing its state-law foreclosure remedy — would "chang[e] the extent to which ACC is secured from what obtained under state law prior to the bankruptcy filing." 90 F.3d, at 1041. Such a departure from state law, the Fifth Circuit said, should be resisted by the federal forum unless "clearly compel[led]" by the Code. Id., at 1042.

The Fifth Circuit then determined that the Code provision governing valuation of security interests, §506(a), does not compel a replacement-value approach. Instead, the court reasoned, the first sentence of §506(a) requires that collateral be valued from the creditor's perspective. See id., at 1044. And because "the creditor's interest is in
the nature of a security interest, giving the creditor the right to repossess and sell the collateral and nothing more[,] . . . the valuation should start with what the creditor could realize by exercising that right." Ibid. This foreclosure-value standard, the Fifth Circuit found, was consistent with the other relevant provisions of the Code, economic analysis, and the legislative history of the pertinent provisions. Judge Smith, joined by five other judges, dissented, urging that the Code dictates a replacement-value standard.

Courts of Appeals have adopted three different standards for valuing a security interest in a bankruptcy proceeding when the debtor invokes the cram down power to retain the collateral over the creditor's objection. In contrast to the Fifth Circuit's foreclosure-value standard, a number of Circuits have followed a replacement-value approach.2 Other courts have settled on the midpoint between foreclosure value and replacement value.

II

The Bankruptcy Code provision central to the resolution of this case is §506(a), which states: "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . 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. . . ." 11 U.S.C. §506(a).

Over ACC's objection, the Rashes' repayment plan proposed, pursuant to §1325(a)(5)(B), continued use of the property in question, i.e., the truck, in the debtor's trade or business. In such a "cram down" case, we hold, the value of the property (and thus the amount of the secured claim under §506(a)) is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller. Rejecting this replacement-value standard, and selecting instead the typically lower foreclosure-value standard, the Fifth Circuit trained its attention on the first sentence of §506(a). In particular, the Fifth Circuit relied on these first sentence words: a claim is secured "to the extent of the value of such creditor's interest in the estate's interest in such property." See 90 F.3d, at 1044 (citing §506(a)). The Fifth Circuit read this phrase to instruct that the "starting point for the valuation [is] what the creditor could realize if it sold the estate's interest in the property according to the security agreement," namely, through "repossess[ing] and sell[ing] the collateral." 90 F.3d, at 1044.

We do not find in the §506(a) first sentence words — "the creditor's interest in the estate's interest in such property" — the foreclosure-value meaning advanced by the Fifth Circuit. Even read in isolation, the phrase imparts no valuation standard: A

2. In re Taffi, the Ninth Circuit contrasted replacement value with fair-market value and adopted the latter standard, apparently viewing the two standards as incompatible. By using the term "replacement value," we do not suggest that a creditor is entitled to recover what it would cost the debtor to purchase the collateral brand new. Rather, our use of the term replacement value is consistent with the Ninth Circuit's understanding of the meaning of fair-market value; by replacement value, we mean the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition.
direction simply to consider the "value of such creditor's interest" does not expressly reveal how that interest is to be valued.

Reading the first sentence of §506(a) as a whole, we are satisfied that the phrase the Fifth Circuit considered key is not an instruction to equate a "creditor's interest" with the net value a creditor could realize through a foreclosure sale. The first sentence, in its entirety, tells us that a secured creditor's claim is to be divided into secured and unsecured portions, with the secured portion of the claim limited to the value of the collateral. To separate the secured from the unsecured portion of a claim, a court must compare the creditor's claim to the value of "such property," i.e., the collateral. That comparison is sometimes complicated. A debtor may own only a part interest in the property pledged as collateral, in which case the court will be required to ascertain the "estate's interest" in the collateral. Or, a creditor may hold a junior or subordinate lien, which would require the court to ascertain the creditor's interest in the collateral. The §506(a) phrase referring to the "creditor's interest in the estate's interest in such property" thus recognizes that a court may encounter, and in such instances must evaluate, limited or partial interests in collateral. The full first sentence of §506(a), in short, tells a court what it must evaluate, but it does not say more; it is not enlightening on how to value collateral.

The second sentence of §506(a) does speak to the question. "Such value, that sentence provides, "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." §506(a). By deriving a foreclosure-value standard from §506(a)'s first sentence, the Fifth Circuit rendered insequential the sentence that expressly addresses how "value shall be determined." As we comprehend §506(a), the "proposed disposition or use" of the collateral is of paramount importance to the valuation question. If a secured creditor does not accept a debtor's Chapter 13 plan, the debtor has two options for handling allowed secured claims: surrender the collateral to the creditor, see §1325(a)(5)(C); or, under the cram down option, keep the collateral over the creditor's objection and provide the creditor, over the life of the plan, with the equivalent of the present value of the collateral, see §1325(a)(5)(B). The "disposition or use" of the collateral thus turns on the alternative the debtor chooses — in one case the collateral will be surrendered to the creditor, and in the other, the collateral will be retained and used by the debtor. Applying a foreclosure-value standard when the cram down option is invoked attributes no significance to the different consequences of the debtor's choice to surrender the property or retain it. A replacement-value standard, on the other hand, distinguishes retention from surrender and renders meaningful the key words "disposition or use." . . .

. . . If a debtor keeps the property and continues to use it, the creditor obtains at once neither the property nor its value and is exposed to double risks: The debtor may again default and the property may deteriorate from extended use. Adjustments in the interest rate and secured creditor demands for more "adequate protection," 11 U.S.C. §361, do not fully offset these risks. . . .

Of prime significance, the replacement-value standard accurately gauges the debtor's "use" of the property. It values "the creditor's interest in the collateral in light of the proposed [repayment plan] reality: no foreclosure sale and economic benefit for the debtor derived from the collateral equal to . . . its [replacement] value." In re Winthrop Old Farm Nurseries, 50 F.3d, at 75. The debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure
sale that will not take place, is the proper guide under a prescription hinged to the property's "disposition or use." See ibid. 4 . . .

Nor are we persuaded that the split-the-difference approach adopted by the Seventh Circuit provides the appropriate solution. Whatever the attractiveness of a standard that picks the midpoint between foreclosure and replacement values, there is no warrant for it in the Code. 5 . . .

In sum, under §506(a), the value of property retained because the debtor has exercised the §1325(a)(5)(B) "cram down" option is the cost the debtor would incur to obtain a like asset for the same "proposed . . . use." 6

For the foregoing reasons, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion. It is so ordered.

Justice STEVENS, dissenting.

Although the meaning of 11 U.S.C. §506(a) is not entirely clear, I think its text points to foreclosure as the proper method of valuation in this case. The first sentence in §506(a) tells courts to determine the value of the "creditor's interest in the estate's interest" in the property. 11 U.S.C. §506(a) (emphasis added). This language suggests that the value should be determined from the creditor's perspective, i.e., what the collateral is worth, on the open market, in the creditor's hands, rather than in the hands of another party.

The second sentence explains that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." Ibid. In this context, the "purpose of the valuation" is determined by 11 U.S.C. §1325(a)(5)(B). Commonly known as the Code's "cram down" provision, this section authorizes the debtor to keep secured property over the creditor's objections in a

4. We give no weight to the legislative history of §506(3), noting that it is un-edifying, offering snippets that might support either standard of valuation. The Senate Report simply repeated the phrase contained in the second sentence of §506(a). That Report, however, appears to use the term "replacement cost" to mean the cost of buying new property to replace property in which a creditor had a security interest. In any event, House Report excerpts are not enlightening, for the provision pivotal here — the second sentence of §506(a) — did not appear in the bill addressed by the House Report. The key sentence originated in the Senate version of the bill. . . .

5. As our reading of §506(a) makes plain; we also reject a ruleless approach allowing use of different valuation standards based on the facts and circumstances of individual cases.

6. Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down 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 debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties, inventory storage, and reconditioning. Nor should the creditor gain from modifications to the property — e.g., the addition of accessories to a vehicle — to which a creditor's lien would not extend under state law.
Chapter 13 reorganization, but, if he elects to do so, directs the debtor to pay the creditor the "value" of the secured claim. The "purpose" of this provision, and hence of the valuation under §506(a), is to put the creditor in the same shoes as if he were able to exercise his lien and foreclose.

It is crucial to keep in mind that §506(a) is a provision that applies throughout the various chapters of the bankruptcy code; it is, in other words, a "utility" provision that operates in many different contexts. Even if the words "proposed disposition or use" did not gain special meaning in the cram down context, this would not render them surplusage because they have operational significance in their many other Code applications. In this context, I also think the foreclosure standard best comports with economic reality. Allowing any more than the foreclosure value simply grants a general windfall to undersecured creditors at the expense of unsecured creditors. As Judge Easterbrook explained in rejecting the split-the-difference approach as a general rule, a foreclosure-value standard is also consistent with the larger statutory scheme by keeping the respective recoveries of secured and unsecured creditors the same throughout the various bankruptcy chapters.

Accordingly, I respectfully dissent.

Interestingly, the security interest in Rash would not have been exempted from lien stripping even had the 2005 amendments applied, because the debtors had purchased the truck three years before they filed for bankruptcy. In re Rash, 31 F.3d 325, 327 (5th Cir. 1994).

In the 2005 Amendments Congress codified something like the Rash rule. §506(a)(2). As we have seen before, however, valuation is at best a difficult and sometimes chancy process. In part because of footnote six, the Rash decision failed to reduce the number of valuation disputes. The language since added to section 506(a)(2) will undoubtedly provoke considerable new interpretive litigation, but the effort is worthwhile. A good attorney who can marshal the best valuation arguments will have a far more significant financial impact than an attorney who concentrates solely on doctrinal issues. All the provisions delineating the position of the secured creditor rest on the assumption that the valuation of the collateral has been established, but valuation will remain the most difficult part of the process.

* The Court states that "surrender and retention are not equivalent acts" from the creditor's perspective because he does not receive the property and is exposed to the risk of default and deterioration. I disagree. That the creditor does not receive the property is irrelevant because, as §1325(a)(5)(B)(ii) directs, he receives the present value of his security interest. Present value includes both the underlying value and the time-value of that interest. The time value component similarly vitiates the risk concern. Higher risk uses of money must pay a higher premium to offset the same opportunity cost. In this case, for instance, the creditor was receiving nine percent interest, well over the prevailing rate for an essentially risk-free loan, such as a United States Treasury Bond. Finally, the concern with deterioration is addressed by another provision of the Code, 11 U.S.C. §361, which authorizes the creditor to demand "adequate protection," including increased payments, to offset any derogation of his security interest during a cram down.
Computing the Amount the Secured Creditor Must Be Paid

Once a court has determined that the security interest in the car was a secured claim, it has to make two factual determinations in order to establish the correct amount for the debtor to pay under the Chapter 13 plan:

1. The amount of the allowed secured claim under section 506(a); and
2. The present value of the allowed secured claim under section 1325(a)(5)(B)(ii).

Once the allowed secured claim is determined, the court can establish a payment schedule that permits the creditor to recover the present value of the claim. The concept of "present value" (in statutory terms, "value, as of the effective date of the Plan," §1325(a)(5)(B)(ii)) reflects the elementary proposition that a dollar paid a year from now is worth less than a dollar paid now. Absent bankruptcy, the secured creditor would be allowed to repossess and sell the collateral today. The creditor would then have that money available for another investment. Because the creditor receives deferred payments over time, the Code gives the creditor the right to receive interest on that amount. The total received by the creditor over time is then equal to the "present value" of the collateral.

Before you conclude that present value is simple in principle but hopelessly complex to compute, we should note that virtually all accounting texts and bankers' manuals carry present value tables, so that once the principal amount, the time for repayment, and the rate of discount are known, the correct monthly payment can be determined from a table. In addition, cheap calculators can now perform the computation. For the math whizzes in the group, a number of formulas can be used to calculate present value. One is given here:

\[ \text{PV}_a = \left( \frac{1-1/ (1+i)^n}{i} \right) \times (a) \]

where  
- \( a \) = a dollar amount of installment payment
- \( i \) = a current annual interest rate
- \( n \) = the number of annual payments

(Computations for other than annual payments require corresponding adjustment of 'i' — e.g., monthly payments use \( i/12 \).)

But perhaps that is a bit much.

Any formula requires the insertion of the factual predicates, value and interest rate. The interest rate that will fix the present value is nowhere in the Code. Years of divided case law on this point finally brought it to the attention of the Supreme Court. This time even more circuits were split even more ways than in Rash.

TILL v. SCS CREDIT CORPORATION
Law of Debtors and Creditors: 2005 Casebook Supplement

Justice STEVENS announced the judgment of the Court and delivered an opinion, in which Justice SOUTER, Justice GINSBURG, and Justice BREYER join.

I

On October 2, 1998, petitioners Lee and Amy Till, residents of Kokomo, Indiana, purchased a used truck from Instant Auto Finance for $6,395 plus $330.75 in fees and taxes. They made a $300 down payment and financed the balance of the purchase price by entering into a retail installment contract that Instant Auto immediately assigned to respondent, SCS Credit Corporation. Petitioners' initial indebtedness amounted to $8,285.24—the $6,425.75 balance of the truck purchase plus a finance charge of 21% per year for 136 weeks, or $1,859.49. Under the contract, petitioners agreed to make 68 biweekly payments to cover this debt; Instant Auto—and subsequently respondent—retained a purchase money security interest that gave it the right to repossess the truck if petitioners defaulted under the contract.

On October 25, 1999, petitioners, by then in default on their payments to respondent, filed a joint petition for relief under Chapter 13 of the Bankruptcy Code. At the time of the filing, respondent's outstanding claim amounted to $4,894.89, but the parties agreed that the truck securing the claim was worth only $4,000. In accordance with the Bankruptcy Code, therefore, respondent's secured claim was limited to $4,000, and the $894.89 balance was unsecured.

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The proposed plan . . . provided that petitioners would pay interest on the secured portion of respondent's claim at a rate of 9.5% per year. Petitioners arrived at this "prime-plus" or "formula rate" by augmenting the national prime rate of approximately 8% (applied by banks when making low-risk loans) to account for the risk of nonpayment posed by borrowers in their financial position. Respondent objected to the proposed rate, contending that the company was "entitled to interest at the rate of 21%, which is the rate . . . it would obtain if it could foreclose on the vehicle and reinvest the proceeds in loans of equivalent duration and risk as the loan" originally made to petitioners.

At the hearing on its objection, respondent presented expert testimony establishing that it uniformly charges 21% interest on so-called "subprime" loans, or loans to borrowers with poor credit ratings, and that other lenders in the subprime market also charge that rate. Petitioners countered with the testimony of an Indiana University-Purdue University Indianapolis economics professor, who acknowledged that he had only limited familiarity with the subprime auto lending market, but described the 9.5% formula rate as "very reasonable" given that Chapter 13 plans are "supposed to be financially feasible." Id., at 43-44. Moreover, the professor noted that respondent's exposure was "fairly limited because [petitioners] are under the supervision of the court." Id., at 43. The bankruptcy trustee also filed comments supporting the formula rate as, among other things, easily ascertainable, closely tied to the "condition of the financial market," and independent of the financial circumstances of any particular lender. App. to

8. The requirement of financial feasibility derives from 11 U.S.C. §1325(a)(6), which provides that the bankruptcy court shall "confirm a plan if . . . the debtor will be able to make all payments under the plan and to comply with the plan." See infra, at 480.
Pet. for Cert. 41a-42a. Accepting petitioners' evidence, the Bankruptcy Court overruled respondent's objection and confirmed the proposed plan.

The District Court reversed. It understood Seventh Circuit precedent to require that bankruptcy courts set cram down interest rates at the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk. Citing respondent's unrebuted testimony about the market for subprime loans, the court concluded that 21% was the appropriate rate. Id., at 38a.

On appeal, the Seventh Circuit endorsed a slightly modified version of the District Court's "coerced" or "forced loan" approach. . . . [T]he majority held that the original contract rate should "serve as a presumptive [cram down] rate," which either the creditor or the debtor could challenge with evidence that a higher or lower rate should apply. Accordingly, the court remanded the case to the Bankruptcy Court to afford petitioners and respondent an opportunity to rebut the presumptive 21% rate.

Dissenting, Judge Rovner argued that the majority's presumptive contract rate approach overcompensates secured creditors because it fails to account for costs a creditor would have to incur in issuing a new loan. Rather than focusing on the market for comparable loans, Judge Rovner advocated either the Bankruptcy Court's formula approach or a "straightforward ... cost of funds" approach that would simply ask "what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source." . . .

II

The Bankruptcy Code provides little guidance as to which of the rates of interest advocated by the four opinions in this case—the formula rate, the coerced loan rate, the presumptive contract rate, or the cost of funds rate—Congress had in mind when it adopted the cram down provision. . . .

. . . A debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is always some risk of nonpayment. The challenge for bankruptcy courts reviewing such repayment schemes, therefore, is to choose an interest rate sufficient to compensate the creditor for these concerns.

Three important considerations govern that choice. First, the Bankruptcy Code includes numerous provisions that, like the cram down provision, require a court to "discount[t] ... [a] stream of deferred payments back to the[ir] present dollar value," Rake v. Wade, 508 U.S. 464, 472, n. 8 (1993), to ensure that a creditor receives at least the value of its claim. We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions. Moreover, we think Congress would favor an approach that is familiar in the financial community and that minimizes the need for expensive evidentiary proceedings.

Second, Chapter 13 expressly authorizes a bankruptcy court to modify the rights of any creditor whose claim is secured by an interest in anything other than "real property that is the debtor's principal residence." 11 U.S.C. §1322(b)(2). Thus, in cases like this involving secured interests in personal property, the court's authority to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract is perfectly clear. Further, the potential need to modify the loan
terms to account for intervening changes in circumstances is also clear: On the one hand, the fact of the bankruptcy establishes that the debtor is overextended and thus poses a significant risk of default; on the other hand, the postbankruptcy obligor is no longer the individual debtor but the court-supervised estate, and the risk of default is thus somewhat reduced.

Third, from the point of view of a creditor, the cram down provision mandates an objective rather than a subjective inquiry. That is, although §1325(a)(5)(B) entitles the creditor to property whose present value objectively equals or exceeds the value of the collateral, it does not require that the terms of the cram down loan match the terms to which the debtor and creditor agreed prebankruptcy, nor does it require that the cram down terms make the creditor subjectively indifferent between present foreclosure and future payment. Indeed, the very idea of a "cram down" loan precludes the latter result: By definition, a creditor forced to accept such a loan would prefer instead to foreclose. 13

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III

These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors—an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cram down loans.

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IV

The formula approach has none of these defects. Taking its cue from ordinary lending practices, the approach begins by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default. Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly.

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13. We reached a similar conclusion in Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997), when we held that a creditor's secured interest should be valued from the debtor's, rather than the creditor's, perspective. Id., at 963 ("[The debtor's] actual use, rather than a foreclosure sale that will not take place, is the proper guide . . .").
Thus, unlike the coerced loan, presumptive contract rate, and cost of funds approaches, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings.

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We do not decide the proper scale for the risk adjustment, as the issue is not before us. The Bankruptcy Court in this case approved a risk adjustment of 1.5%, and other courts have generally approved adjustments of 1% to 3%... If the court determines that the likelihood of default is so high as to necessitate an "eye-popping" interest rate, the plan probably should not be confirmed.

V

The dissent's endorsement of the presumptive contract rate approach rests on two assumptions: (1) "subprime lending markets are competitive and therefore largely efficient"; and (2) the risk of default in Chapter 13 is normally no less than the risk of default at the time of the original loan. Although the Bankruptcy Code provides little guidance on the question, we think it highly unlikely that Congress would endorse either premise.

First, the dissent assumes that subprime loans are negotiated between fully informed buyers and sellers in a classic free market. But there is no basis for concluding that Congress relied on this assumption when it enacted Chapter 13. Moreover, several considerations suggest that the subprime market is not, in fact, perfectly competitive.

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Second, the dissent apparently believes that the debtor's prebankruptcy default—on a loan made in a market in which creditors commonly charge the maximum rate of interest allowed by law and in which neither creditors nor debtors have the protections afforded by Chapter 13—translates into a high probability that the same debtor's confirmed Chapter 13 plan will fail. In our view, however, Congress intended to create a program under which plans that qualify for confirmation have a high probability of success. Perhaps bankruptcy judges currently confirm too many risky plans, but the solution is to confirm fewer such plans, not to set default cram down rates at absurdly high levels, thereby increasing the risk of default.

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Even more important, if all relevant information about the debtor's circumstances, the creditor's circumstances, the nature of the collateral, and the market for comparable loans were equally available to both debtor and creditor, then in theory the formula and presumptive contract rate approaches would yield the same final interest rate. Thus, we principally differ with the dissent not over what final rate courts should adopt but over which party (creditor or debtor) should bear the burden of rebutting the presumptive rate (prime or contract, respectively).

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If the rather sketchy data uncovered by the dissent support an argument that Chapter 13 of the Bankruptcy Code should mandate application of the presumptive contract rate approach (rather than merely an argument that bankruptcy judges should exercise greater caution before approving debt adjustment plans), those data should be forwarded to Congress. We are not persuaded, however, that the data undermine our interpretation of the statutory scheme Congress has enacted.

The judgment of the Court of Appeals is reversed, and the case is remanded with instructions to remand the case to the Bankruptcy Court for further proceedings consistent with this opinion.

It is so ordered.

Justice THOMAS, concurring in the judgment.

This case presents the issue of what the proper method is for discounting deferred payments to present value and what compensation the creditor is entitled to in calculating the appropriate discount rate of interest. Both the plurality and the dissent agree that "[a] debtor's promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is always some risk of nonpayment." Ante, at 1958; post, at 1968. Thus, the plurality and the dissent agree that the proper method for discounting deferred payments to present value should take into account each of these factors, but disagree over the proper starting point for calculating the risk of nonpayment.

I agree that a "promise of future payments is worth less than an immediate payment" of the same amount, in part because of the risk of nonpayment. But this fact is irrelevant. The statute does not require that the value of the promise to distribute property under the plan be no less than the allowed amount of the secured creditor's claim. It requires only that "the value ... of property to be distributed under the plan," at the time of the effective date of the plan, be no less than the amount of the secured creditor's claim. 11 U.S.C. §1325(a)(5)(B)(ii) (emphasis added). Both the plurality and the dissent ignore the clear text of the statute in an apparent rush to ensure that secured creditors are not undercompensated in bankruptcy proceedings.

The dissent might be correct that the use of the prime rate, even with a small risk adjustment, "will systematically undercompensate secured creditors for the true risks of default." Post, at 1968. This systematic undercompensation might seem problematic as a matter of policy. But, it raises no problem as a matter of statutory interpretation.

The final task, then, is to determine whether petitioners' proposed 9.5% interest rate will sufficiently compensate respondent for the fact that instead of receiving $4,000 today, it will receive $4,000 plus 9.5% interest over a period of up to 36 months. Because the 9.5% rate is higher than the risk-free rate, I conclude that it will. I would therefore reverse the judgment of the Court of Appeals.

Justice SCALIA, with whom THE CHIEF JUSTICE, Justice O'CONNOR, and Justice KENNEDY join, dissenting.
Our only disagreement is over what procedure will more often produce accurate estimates of the appropriate interest rate. The plurality would use the prime lending rate—a rate we know is too low—and require the judge in every case to determine an amount by which to increase it. I believe that, in practice, this approach will systematically undercompensate secured creditors for the true risks of default. I would instead adopt the contract rate—i.e., the rate at which the creditor actually loaned funds to the debtor—as a presumption that the bankruptcy judge could revise on motion of either party. Since that rate is generally a good indicator of actual risk, disputes should be infrequent, and it will provide a quick and reasonably accurate standard.

I

The contract-rate approach makes two assumptions, both of which are reasonable. First, it assumes that subprime lending markets are competitive and therefore largely efficient. If so, the high interest rates lenders charge reflect not extortionate profits or excessive costs, but the actual risks of default that subprime borrowers present. Lenders with excessive rates would be undercut by their competitors, and inefficient ones would be priced out of the market. We have implicitly assumed market competitiveness in other bankruptcy contexts. Here the assumption is borne out by empirical evidence: One study reports that subprime lenders are nearly twice as likely to be unprofitable as banks, suggesting a fiercely competitive environment. See J. Lane, Associate Director, Division of Supervision, Federal Deposit Insurance Corporation, A Regulator's View of Subprime Lending: Address at the National Automotive Finance Association Non-Prime Auto Lending Conference 6 (June 18-19, 2002) (available in Clerk of Court's case file).

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The second assumption is that the expected costs of default in Chapter 13 are normally no less than those at the time of lending. This assumption is also reasonable. Chapter 13 plans often fail. I agree with petitioners that the relevant statistic is the percentage of confirmed plans that fail, but even resolving that issue in their favor, the risk is still substantial. The failure rate they offer—which we may take to be a conservative estimate, as it is doubtless the lowest one they could find—is 37%. See Girth, The Role of Empirical Data in Developing Bankruptcy Legislation for Individuals, 65 Ind. L.J. 17, 40-42 (1989) (reporting a 63.1% success rate).1 In every one of the failed plans making up that 37%, a bankruptcy judge had found that "the debtor will be able to

1. The true rate of plan failure is almost certainly much higher. The Girth study that yielded the 37% figure was based on data for a single division (Buffalo, New York) from over 20 years ago (1980-1982). See 65 Ind. L. J., at 41. A later study concluded that "the Buffalo division had achieved extraordinary results, far from typical for the country as a whole." Whitford, The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy, 68 Am. Bankr.L.J. 397, 411, n. 50 (1994). Although most of respondent's figures are based on studies that do not clearly exclude unconfirmed plans, one study includes enough detail to make the necessary correction: It finds 32% of filings successful, 18% dismissed without confirmation of a plan, and 49% dismissed after confirmation, for a postconfirmation failure rate of 60% (i.e., 49%/(32% + 49%)). See Norberg, Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13, 7 Am. Bankr. Inst. L.Rev. 415, 440-441 (1999). This 60% failure rate is far higher than the 37% reported by Girth.
make all payments under the plan," 11 U.S.C. §1325(a)(6), and a trustee had supervised the debtor's compliance, §1302. That so many nonetheless failed proves that bankruptcy judges are not oracles and that trustees cannot draw blood from a stone.

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II

The defects of the formula approach far outweigh those of the contract-rate approach. The formula approach starts with the prime lending rate—a number that, while objective and easily ascertainable, is indisputably too low. It then adjusts by adding a risk premium that, unlike the prime rate, is neither objective nor easily ascertainable. ***** When the risk premium is the greater part of the overall rate, the formula approach no longer depends on objective and easily ascertainable numbers. The prime rate becomes the objective tail wagging a dog of unknown size.

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III

Justice THOMAS rejects both the formula approach and the contract-rate approach. He reads the statutory phrase "property to be distributed under the plan," 11 U.S.C. §1325(a)(5)(B)(ii), to mean the proposed payments if made as the plan contemplates, so that the plan need only pay the risk-free rate of interest. Ante, at 1966 (opinion concurring in judgment). I would instead read this phrase to mean the right to receive payments that the plan vests in the creditor upon confirmation. Because there is no guarantee that the promised payments will in fact be made, the value of this property right must account for the risk of nonpayment.

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Circuit authority uniformly rejects the risk-free approach. While Circuits addressing the issue are divided over how to calculate risk, to my knowledge all of them require some compensation for risk, either explicitly or implicitly. *****

There are very good reasons for Congress to prescribe full risk compensation for creditors. Every action in the free market has a reaction somewhere. If subprime lenders are systematically undercompensated in bankruptcy, they will charge higher rates or, if they already charge the legal maximum under state law, lend to fewer of the riskiest borrowers. As a result, some marginal but deserving borrowers will be denied vehicle loans in the first place. Congress evidently concluded that widespread access to credit is worth preserving, even if it means being ungenerous to sympathetic debtors.

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Today's judgment is unlikely to burnish the Court's reputation for reasoned decisionmaking. Eight Justices are in agreement that the rate of interest set forth in the debtor's approved plan must include a premium for risk. Of those eight, four are of the view that beginning with the contract rate would most accurately reflect the actual risk,
and four are of the view that beginning with the prime lending rate would do so. The
ninth Justice takes no position on the latter point, since he disagrees with the eight on the
former point; he would reverse because the rate proposed here, being above the risk-free
rate, gave respondent no cause for complaint. Because I read the statute to require full
risk compensation, and because I would adopt a valuation method that has a realistic
prospect of enforcing that directive, I respectfully dissent.

If someone put us on the Supreme Court we would promise not to be grumpy (at
least in print) and to try to give the lower courts a reasonably clear idea of what we want
them to do.

Cramdown is one of two processes by which a debtor can reduce an undersecured
claim to the value of the collateral. The other is redemption under section 722, which we
discussed earlier in the book. (Another term used by the cognoscenti for either of these
processes is lien stripping.) A Chapter 13 plan has a great advantage over redemption
because in Chapter 13 a debtor can pay the value of the collateral over time, in
installments. Notice, however, that the same result is obtained under the retention cases.
Retention by a Chapter 7 debtor is actually better than a Chapter 13 plan in one respect,
because the Chapter 7 debtor discharges personal liability. A Chapter 13 debtor gets no
discharge until the plan is completed (with a rarely used exception in section 1328(b)). If
the Chapter 13 debtor defaults, all the personal liability for a deficiency remains with the
debtor. Chapter 13 does have an advantage over retention, however, because the
automatic stay in Chapter 13 also lasts until that late discharge, which means that a
defaulting debtor is protected from repossession by the automatic stay while the debtor
makes the required payments. If a post–Chapter 7 debtor wants to retain the collateral, a
secured creditor may be able to repossess without going to court, but the creditor must
seek to lift the stay against a Chapter 13 debtor. These differences aside, lien stripping is
yet another area in which we find that Chapter 7 and Chapter 13 are not dichotomous, but
simply different places on a continuum.

3. Payments on the Home Mortgage

The preceding section covered the determination of the allowed secured claim for a
creditor with a security interest in personal property. For more than half the debtors in
Chapter 13, however, their single biggest asset is their home. These debtors structure
their plans around their home mortgage payments to avoid foreclosure. The debtors in
many homestead Chapter 13 cases have delayed seeking legal help and often their
financial circumstances have deteriorated significantly. By the time they see a bankruptcy
lawyer, many of these debtors face imminent foreclosure proceedings. For such debtors,
filings for Chapter 13 may be the only way to save a home that is slipping into the
creditor's hands.

We mentioned earlier that one type of security interest has always been exempted
from the cramdown rule: the home mortgage. Some courts had attempted to work around
this exemption, and permit home mortgage cramdowns, but the Supreme Court in
Nobelman v. American Saving Bank, 508 U.S. 324 (1993) made it clear that cramdown
would not apply to home mortgages. The result is that the only relief in Chapter 13 as to
a home mortgage is to "cure and maintain," that is, to catch up on the past-due arrearage while making current payments on the mortgage as they come due. §1322(b)(5).

While the lien stripping question was important for the debtors with mortgages that exceeded the value of their homes, for many debtors the home represents an asset even in bankruptcy. Debtors often have some equity in their homes either because the lender has financed less than 100 percent of the value of a home, or because residential real estate prices have risen rather than declined in value over time. As a result, in the Chapter 13 cases that center on saving the debtor's home, the issue of adequate protection may be less important than in the personal property area. Whenever the value of the home exceeds the mortgage, the mortgagee will nearly always be adequately protected.

Litigation in these Chapter 13 cases is more likely to involve two other problems: (1) in the short term, saving the home from foreclosure sale, and (2) in the long term, proposing a plan to comply with the strict limitations imposed by the provisions of Chapter 13 to protect the rights of mortgage lenders.

In the following case, the debtors propose a Chapter 13 plan in order to save their home from foreclosure. Note two elements in this case: (1) the difficulties the debtors face in stopping their creditor's foreclosure actions, and (2) the amount they must pay on their mortgages during the period of the plan in order to satisfy the Code provisions.

In re TADDEO
685 F.2d 24 (2d Cir. 1982)

LUMBARD, Circuit Judge.

Joseph C. and Ellen A. Taddeo live at 6 Ort Court, Sayville, New York. Three years ago they defaulted on their mortgage to Elfredie Di Pierro. Di Pierro accelerated the mortgage, declared its balance due immediately, and initiated foreclosure proceedings. The Taddeos sought refuge under Chapter 13 of the new Bankruptcy Code, staying the foreclosure action under the automatic stay, §362(a), and proposing to cure the default and reinstate the mortgage under §1322(b)(5). Di Pierro is listed as the Taddeos' only creditor. She rejected the plan to cure the default, and applied for relief from the automatic stay in order to foreclose. Di Pierro contended that once she accelerated her mortgage, the Taddeos had no way to cure the default under the Bankruptcy Code except to pay the full amount as required by state law. Bankruptcy Judge Parente held that the Taddeos could cure the default and reinstate their mortgage, and denied Di Pierro's motion for relief from the stay. In re Taddeo, 9 B.R. 299 (Bankr. E.D.N.Y. 1981). Judge Pratt affirmed, 15 B.R. 273 (Bankr. E.D.N.Y. 1981). We affirm. We do not believe that Congress labored for five years over this controversial question only to remit consumer debtors — intended to be primary beneficiaries of the new Code — to the harsher mercies of state law.

Di Pierro originally owned the house at 6 Ort Court. On June 14, 1979, she sold the house to the Taddeos, taking in return a "purchase money second mortgage" to secure a principal balance of $13,000. The property is subject to a first lien held by West Side Federal Savings & Loan Association, which is not involved in this case. Di Pierro's second mortgage was payable over 15 years at 8.5 percent in equal monthly installments of $128.05.

Upon taking occupancy, the Taddeos notified Di Pierro that they had discovered defects in the property. On advice of counsel, the Taddeos said they would withhold
mortgage payments, depositing the money instead with their attorney. The Taddeos and Di Pierro corresponded for several months without reaching an agreement. On October 5, 1979, Di Pierro wrote that she was accelerating the mortgage and declaring the entire balance due immediately. The mortgage contained the acceleration clause specifically approved in N.Y. Real Prop. §258 Schedule M (McKinney 1968), which gives the mortgagee the option to accelerate after a default in mortgage payments.

Di Pierro commenced foreclosure proceedings in state court on October 19, 1979. The Taddeos tendered full payment of their arrears by check on October 31, 1979, but Di Pierro refused to accept payment. The state court granted summary judgment to Di Pierro and ordered a referee to determine the amount owed. After a hearing on June 30, 1980, the referee found the Taddeos liable for $14,153.48 in principal and interest, plus interest subsequent to the award.

Before Di Pierro could obtain final judgment of foreclosure and sale, the Taddeos filed a Chapter 13 bankruptcy petition in the Eastern District on July 10, 1980. . . . The petition listed Di Pierro as the only creditor, and stayed Di Pierro's foreclosure action. The Taddeos filed a plan proposing to pay off arrears on the mortgage in installments of $100 per month. The plan further proposed to restore the mortgage and its original payment schedule, with payments through [the] trustee to Di Pierro during the 3-year life of the plan and directly to Di Pierro after the plan ended. Di Pierro objected to the plan, and petitioned for relief from the automatic stay so that she could proceed with her foreclosure action. Di Pierro contended that her rights as mortgagee could not be affected by the Chapter 13 plan. . . .

When Congress empowered Chapter 13 debtors to "cure defaults," we think Congress intended to allow mortgagors to "de-accelerate" their mortgage and reinstate its original payment schedule. We so hold for two reasons. First, we think that the power to cure must comprehend the power to "de-accelerate." This follows from the concept of "curing a default." A default is an event in the debtor-creditor relationship which triggers certain consequences — here, acceleration. Curing a default commonly means taking care of the triggering event and returning to pre-default conditions. The consequences are thus nullified. This is the concept of "cure" used throughout the Bankruptcy Code. Such legislative history as there is supports a similar reading of §1322(b)(5). Both the Bankruptcy Commission's Bill . . . and the Bankruptcy Judges' Bill . . . plainly permitted the cure and de-acceleration of residential debt accelerated prior to petition. . . .

H.R. 6 adopted language almost identical to §6-301(2) of the Commission's Bill, which accomplished just what the Judges' Bill did, albeit in different language. In fact, H.R. 6 went beyond either of its predecessors and permitted the modification of debt secured by a debtor's residence. Although the Senate later adopted a prohibition against modification of the rights of holders of secured real estate debt, S. 2266, 95th Cong. 2d Sess. §1322(b)(2), which the House accepted insofar as it related to debt secured by a debtor's principal residence, 124 Cong. Rec. H.R. 106 (September 28, 1978), the cure and maintain powers of paragraph (b)(5) remained unchanged. This history and the policy discussed above compel the conclusion that §1322(b)(5) was intended to permit the cure and de-acceleration of secured long-term residential debt accelerated prior to the filing of a Chapter 13 petition.

Policy considerations strongly support this reading of the statute. Conditioning a debtor's right to cure on its having filed a Chapter 13 petition prior to acceleration would prompt unseemly and wasteful races to the courthouse. Worse, these would be races in which mortgagees possess an unwarranted and likely insurmountable
advantage: Wage earners seldom will possess the sophistication in bankruptcy matters that financial institutions do, and often will not have retained counsel in time for counsel to do much good. In contrast, permitting debtors in the Taddeos' position to de-accelerate by payment of the arrearages will encourage parties to negotiate in good faith rather than having to fear that the mortgagee will tip the balance irrevocably by accelerating or that the debtor may prevent or at least long postpone this by filing a Chapter 13 petition.

Secondly, we believe that the power to "cure any default" granted in §1322(b)(3) and (b)(5) is not limited by the ban against "modifying" home mortgages in §1322(b)(2) because we do not read "curing defaults" under (b)(3) or "curing defaults and maintaining payments" under (b)(5) to be modifications of claims.

It is true that §1322(b)(5)'s preface, "notwithstanding paragraph (2)," seems to treat the power to cure in (b)(5) as a subset of the power to modify set forth in (b)(2), but that superficial reading of the statute must fall in the light of legislative history and legislative purpose. The "notwithstanding" clause was added to §1322(b)(5) to emphasize that defaults in mortgages could be cured notwithstanding §1322(b)(2). See 124 Cong. Rec. H.R. 106 (Sept. 28, 1978); S. 17,423 (Oct. 6, 1978). But the clause was not necessary. The Senate protected home mortgages from modification in its last bill, S. 2266, 95th Cong., 2d Sess.; it evinced no intent to protect these mortgages from cure. Cf. Hearings on S. 2266 Before the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary 95th Cong., 1st Sess. 836 (1977) (Statement of Charles A. Horsky, Chairman, National Bankruptcy Conference (S. 2266 "is completely unclear as to whether the plan can provide for the curing of defaults and the making of current payments.")). Indeed, earlier Senate bills along with House bills and the present statute listed the power to cure and the power to modify in different paragraphs, indicating that the power to cure is different from the power to modify. Testimony submitted on behalf of secured creditors distinguished between modifying a claim (by reducing payments due thereon) and curing a default (and maintaining those payments). See Hearings Before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94th Cong., 1st Sess, 1027 (Statement of Walter W. Vaughan on behalf of the American Bankers Association); Hearings Before the Subcommittee on Improvements in the Judicial Machinery of the Senate Committee on the Judiciary, 94th Cong., 1st Sess. 130 (idem). Finally, the few cases under Chapter XIII of the old Bankruptcy Act distinguished between modifying a claim and maintaining payments thereon and indicate that curing a default and maintaining payments on a claim did not modify that claim.

Our reading of the statute disposes of Di Pierro's major contentions on appeal. Di Pierro argues that the Taddeos cannot use §1322(b)(5) to cure their default and maintain payments on her mortgage because (b)(5) applies only to claims whose last payment is due after the last payment under the plan is due. Di Pierro maintains her acceleration of the mortgage makes all payments due now. But we hold that the concept of "cure" in §1322(b)(5) contains the power to de-accelerate. Therefore the application of that section de-accelerates the mortgage and returns it to its 15-year maturity. Alternatively, we hold that the ban on "modification" in §1322(b)(2) does not limit the Taddeos' exercise of their curative powers under either §1322(b)(3) or (b)(5). Therefore the Taddeos may first cure their default under (b)(3) and then maintain payments under (b)(5). . . .
Di Pierro argues further that §1322(b)(5) requires the Taddeos to cure their default "within a reasonable time" and that under New York law that time has passed. But clearly the "reasonable time" requirement refers to time after a Chapter 13 petition is filed. Otherwise Chapter 13 debtors would forfeit their right to cure merely by negotiating with their creditors, or, as in this case, litigating the right of their creditor to declare a default. The bankruptcy courts which have allowed Chapter 13 debtors to cure defaults under §1322(b)(5) have assumed that "reasonable time" refers to time after the petition was filed. We find no support for Di Pierro's contention that state law must govern what constitutes a reasonable time.

Di Pierro's argument reduces in the end to an assertion that because she can accelerate her mortgage under state law, the Taddeos can cure only as provided by state law. This interpretation of §1322(b) would leave the debtor with fewer rights under the new Bankruptcy Code than under the old Bankruptcy Act of 1898. Defaulting mortgagees would forfeit their right to cure even before the start of foreclosure proceedings, before they have hired lawyers and therefore before they knew anything about their rights under Chapter 13. Such a result would render the remedy in §1322(b) unavailable to all but a select number of debtors. Such a result would be totally at odds with the "overriding rehabilitative purpose of Chapter 13." In re Davis, 15 B.R. 22, 24 (Bankr. D. Kan.), aff'd, 16 B.R. 473 (D. Ran. 1981).

Affirmed.

As Taddeo makes clear, the Code did not originally address the de-acceleration question, leaving it instead for the courts to fashion this important exception to section 1322(b)(2). Following Nobelman, some courts thought that the plain meaning of §1322(b)(2) meant that if the contract said "no de-acceleration" then the debtor could not force de-acceleration on an unwilling mortgagee, although Justice Thomas had indicated that de-acceleration was probably allowed. Evidently, some meanings are plainer than others. In any case, Congress intervened with the 1994 Amendments, giving homeowners the right to de-accelerate by statute at any time prior to the foreclosure sale. §1322(c).

The recent growth in second mortgages may affect the use of Chapter 13. Notwithstanding the restriction imposed by section 1322(b)(2), some courts have read sections 506 and 1325 to permit a strip down for a second or subsequent home mortgage that is entirely unsecured. A second mortgage would be entirely undersecured if, for example, the home were worth $200,000 and the first mortgage was for $210,000. Any subsequent mortgages would be wholly—not just partially—unsecured. The courts that permit strip down in such circumstances take the position that a wholly unsecured second mortgage is no longer under the protection afforded mortgages "in real property that is the debtor's principal residence." Because these subsequent mortgages could not be removed at state law, Chapter 13 becomes an attractive device for stripping down a home mortgage in some limited cases.

Problem Set 14

14.1. Fran Belinsky is a graphic artist with an income in excess of $52,000 per year. Last year she guaranteed a large business loan for her brother. Her brother
skipped town, and now Fran is left to pay the loan. She has filed a Chapter 13 and plans to make a substantial repayment.

Fran’s only asset of significant value is an eighteen-month-old Apple G5 computer with high-end peripherals that is subject to a valid $4,600 purchase money security interest from InterNet CompFinance. She testified at her 341 meeting that it is worth about $5,000. The IC people think that value is about right for now, but IC wants the computer back so that it can resell the computer before Apple announces a new cheaper model with enhanced features. IC asks for your help in repossessing the computer. What can you do? See §§361, 362(d).

14.2. George Grey has suffered a series of financial reversals. He was laid off from his job as a steel worker for 17 months, he has incurred medical bills for over $20,000 for his younger daughter, and his son just wrecked the car. But things may be looking up for George now. He has been rehired and is working nearly 20 hours per week overtime. Recognizing that he needs some protection from his creditors, he is prepared to file a Chapter 13.

His chief concern at this point is his hunting cabin. Before he was laid off, he had bought the land from LeisureLand, Inc. for no money down and a $40,000 five-year note. During the time he was unemployed, he went out to the site almost every day. He cleared the land and built a one-room cabin with the materials he found on hand. The place has no plumbing or electricity, but George loves it. And now he is afraid he will lose it.

George made only four payments on the land; the principal balance owed is $39,980. In addition, LeisureLand claims $12,300 in past-due interest, penalties, and attorneys' fees provided for under the contract. They have begun foreclosure proceedings, and the land is scheduled for sale next week. The contract interest rate is now running at 14 percent on the principal balance and 21 percent on all accumulated past-due payments and penalties. Because the area where George lives is in a serious economic slump, even with George’s improvements the land would not sell for more than $41,000. What can LeisureLand demand in a Chapter 13? See §§506, 1322(b)(2), 1325(a)(5)(B)(ii).

14.3. Jewel Snitz has filed a Chapter 13 bankruptcy. She owns a Ford Explorer she bought about a year ago to haul around her real estate clients and to take to the beach on weekends. The outstanding loan balance, together with accumulated interest and penalty payments, is $30,000. During the period between filing the Chapter 13 and the confirmation of the plan, another $250 in interest will accumulate. The local bankruptcy court has settled on 10 percent as a market interest rate for fully secured car loans in Chapter 13.

The Dealer's Bluebook (retail value) lists the value of the car as $32,100. The Dealer's Redbook (wholesale value) lists its value as $28,400. At a liquidation sale the car would probably bring $26,300. Through a private want ad it would likely sell for $33,300. How much will Jewel have to pay for her car in a Chapter 13? If the car has some unusual scratches, chipped paint, and a funny little knock in the engine, who will want to point that out? See §§506(a), 1325(a).

14.4. Eric Van Horn is a skilled workman who has been in high demand during the local housing boom of the last three years. He is also a devoted soccer coach and a year ago couldn’t resist buying a Suburban into which he can get the entire soccer team, even though “it was quite a stretch for me financially.” Unfortunately, the local housing crash followed and the Suburban wasn’t his only financial stretch. He is considering a Chapter 13 to get his debt load under control and needs to know how much it will cost him each month to hold on to the Suburban.

He bought the vehicle for $2,000 down and $40,000 on a sixty-month, 8 percent note. The various value references (bluebook retail, newspaper ads, etc.) suggest it is
now worth about $28,000 (Eric mentioned the big chocolate stain on the middle seat), so it has depreciated about 30 percent in its first year. Prior experience with Suburbs suggests that it will depreciate roughly another 20 percent by next year ($22,400), 15 percent in year three ($19,000), 10 percent in year four ($17,100), and 10 percent in year five ($15,400). He's been paying $841 a month on the vehicle and is up to date on his payments so far. The balance on the note is about $34,000. How much principal debt will he have to pay in total, ignoring interest?

The prime rate is 7.5 percent at the moment and the going rate for a fully secured car loan in the area is still around 8 percent. What interest rate will the court likely approve?

Eric is anxious to match his obligations under a plan with his likely cash flow, “as far as I can guesstimate it.” See §506(a), 1325(a). Once he files, when must he make his first car payment? To whom? See §1326(a)(1). Can he figure his payment by simply consulting a loan table for the principal payment at the given interest rate or is a further calculation required? See §1325(a)(5)(B)(iii). (For an example of a loan table, see www.freemortgageanalyzer.com/mortgage/mortgage.html.)

14.5. Donnie Rhodes bought a house seven years ago and took out a 30-year mortgage to finance the purchase. The home is now valued at $155,000, and the outstanding mortgage is $182,000. Rhodes is required to make monthly payments of $250.

Rhodes sells farm machinery, and as the farming industry took a nosedive, so did Rhodes's sales. He went for eight months with no income, but now things have picked up and he is back to his regular earnings. He has decided to go into Chapter 13 to restructure his debts, but he remains worried about his home. After seven years of regular mortgage payments, Rhodes missed six payments in a row. What must his plan provide? See §1322(b)(2), (b)(5).

14.6. Joe and Ethel Gertz have come to see you for help. They fell behind in the payments on their home after Joe was laid off. They received a notice of acceleration and foreclosure from the savings and loan, but they have lost the notice itself, and the man at the savings and loan hasn't returned their calls. Ethel remembers that today's date was in the notice, but doesn't remember what it said would happen today. What do you advise? What should you do? §§ 109(h), 521(b).

14.7. Mr. and Mrs. Poltz are a small, neat couple who have sat in front of your desk for an hour and a half without a single smile. They are hoping you can save their home. Mr. Poltz was an inventory control clerk for the Phoenix school district, but was hurt about two years ago and has been "on disability" since that time. Because the school district has good disability benefits, he is receiving about $2900 a month. They have only modest personal possessions worth about $4,000, all of which would be exempt. The small equity they have in their house would also be exempt.

Mrs. Poltz is not employed. After paying their spartan expenses and their mortgage, they have about $150 a month left over. After Mr. Poltz was injured, they ran up credit card bills and borrowed some money unsecured from a local finance company, "always thinking Mr. P would be back to work in just a little time." They have $10,750.42 in unsecured debts. They missed three payments on the house when Mr. Poltz's disability checks were stopped because of a computer error. The bank filed a foreclosure suit and an answer is due tomorrow, but the bank officer called last week and said they would be willing to work things out. The Poltzes say they can pick up the current payments on the mortgage and pay the arrears within three months. They have heard about Chapter 13 being used for saving a home, and they are willing to pay the full $150 a month to a plan "for as long as you say." You have no doubt you could get their Chapter 13 plan confirmed. What is your advice?
4. Payments to Unsecured Creditors

To deal with the secured creditors and prevent repossession of the property subject to the security interests, a debtor in Chapter 13 must make payments that satisfy the statutory requirements for the present value of the allowed secured claim. In addition, all priority claimants under section 507 are entitled to payment in full. §1322(2). The general unsecured creditors do not have any similar protection for their claims. Instead, these creditors are pooled together for pro rata treatment.

The unsecured creditors can best enhance their position by arguing that the debtor should be required to make larger payments under the plan. By forcing the debtor to increase the amount available to all creditors, each creditor can share pro rata in a larger pie. Unsecured creditors can make that argument under two provisions of section 1325. The first provision, the "best interests" test, requires that each creditor, secured or unsecured, receive at least as much as that creditor would have received if the debtor had gone into Chapter 7. §1325(a)(4). The second provision is that the debtor must devote all "disposable income" to plan payments during the life of the plan. §1325(b). In addition, a plan must be proposed in "good faith and not by any means forbidden in law." §1325(a)(3).

a. Disposable Income

In 1984, when Congress added the requirement that debtors in Chapter 13 devote all their disposable income to their Chapter 13 plans, the legislators left it to the courts to sort out how to count both income and expenses in order to determine a debtor's disposable income. As with “substantial abuse” screening in Chapter 7, however, the credit industry was unhappy with the results, arguing that the judges were being too easy on debtors who could not only pay, but pay more. In response, Congress included provisions in the 2005 Amendments delineating a disposable income test that parallels the means test it had fashioned for Chapter 7 (see above pp. 49-57).

As with the Chapter 7 means test, the screening starts with a median-income test. For the purposes of this screening, a married debtor who files alone must nonetheless include spousal income in determining whether the debtor's income is above the state median. §1325(b)(4)(A)(ii). Debtors who have incomes below the median and who choose nonetheless to file for Chapter 13 are past the threshold test, so they are governed by a slightly modified version of the “reasonably necessary” test for disposable income adopted in 1984.

Those debtors who have income in excess of the applicable median suffer two adverse consequences. First, they must propose to keep paying for five years under their Chapter 13 plan, rather than the three year minimum required of below-median debtors. §1325(b)(4). Second, because the Chapter 7 means test applies here too, if the debtors would have been barred from Chapter 7 because of a surplus of income over expenses, the amount of that surplus is what they are required to pay to unsecured nonpriority creditors in a Chapter 13 plan. §1325(b)(2)-(3). These are two separate tests, so that a debtor with income over the median must pay for five years, whether or not the debtor has a surplus of income over expenses under the means test.
Consistent with the dichotomous treatment created by this structure, we begin with the general disposable income test for confirmation of a Chapter 13 plan for below-median debtors and then address the situation of above-median debtors. Keep in mind that below-median debtors are seeking Chapter 13 even though they would have been eligible for Chapter 7 liquidation—much like the situation for most debtors regardless of income who filed before October 2005. The 2005 Amendments made only small changes in the Chapter 13 rules that would affect below-median debtors, so the caselaw that once governed every debtor who filed for Chapter 13 would seem to continue to govern the debtors with below-median incomes.

Our data from the 2001 study of the Consumer Bankruptcy Project indicate that 11 percent of the Chapter 13 debtors in 2001 would have had incomes at or above their state median. As with the Chapter 7 debtors, that would still represent a substantial absolute number: almost 50,000 debtors and their families per year. Nonetheless, the converse is that most Chapter 13 debtors will continue to be governed by the prior case law unless, of course, they decide to go to Chapter 7.

To calculate a debtor's disposable income, there are two obvious components: income and necessary expenses. If it would seem to be a simple matter to determine a debtor's income, the following case highlights an unexpected complication.

In re CARTER

Diane Weiss Sigmund, Bankruptcy Judge . . .

The Debtor, Christine Ann Carter, is a married woman residing in Delaware County, Pennsylvania, with her husband, Charles S. Carter, in a house they own as tenants by the entireties. Prior to the filing of the bankruptcy, Styskal [an unsecured creditor of Carter] filed a foreign judgment in Delaware County entered against the Debtor and her husband in the amount of $255,970.27 . . . . The case was filed by her alone, without her husband. By December 18th the Debtor filed her schedules, statement of financial affairs and Chapter 13 plan. On the schedules, the Debtor listed monthly income of $600 and monthly expenses of $500 for herself alone, excluding the income and expenses of her husband.

. . . The plan calls for payments from the Debtor in the amount of $75 per month for 36 months.

On April 24, 1996, Styskal filed the present objection to the Debtor's plan. The objection raised a number of issues, including whether the plan provided for the payment of all of the Debtor's projected disposable income under 11 U.S.C. §1325(b) and whether it was filed in good faith. Styskal's objection to confirmation calls into question the role of a nondebtor spouse's income when a married person individually files a petition for relief under Chapter 13.

On July 24, 1996, at a hearing on confirmation of the Debtor's plan, Styskal pressed her objection and pointed out that the Debtor failed to provide full disclosure of her family's financial status by neglecting to list the income and expenses of her husband. Although Styskal presented no evidence on the issue, she alleged that Charles Carter had a high income, in the range of $90,000, which should have [been] disclosed on the Debtor's
schedules. We took the matter under advisement and requested the parties to submit memorandums in support of their positions.

DISCUSSION

Upon objection by an unsecured creditor or the trustee, a Chapter 13 plan that does not repay the allowed claims of unsecured creditors in full may only be confirmed if it provides for the debtor to commit all of his disposable income for a 36 month period to plan payments. 11 U.S.C. §1325(b)(1)(B). Disposable income is defined as income received by the debtor that is not reasonably necessary for the support of debtor or his dependents. 11 U.S.C. §1325(b)(2)(A). Although the Code does not define what is reasonable and necessary, case law holds that the standard is directed toward the debtor's basic need for support, unrelated to the debtor's former status and lifestyle. Ordinarily, expenditures for necessary non-luxury items are not questioned, but the existence of expenditures on such items raises concerns as to the propriety of the debtor's budget. To apply these provisions to a married debtor who files individually, courts base their calculation of the debtor's disposable income on the debtor's family budget, including the income and expenses of the nondebtor spouse. Consideration of the nondebtor spouse's income is seen as necessary because a portion of that spouse's income is likely to be applied to the basic needs of the debtor, potentially increasing the share of the debtor's own income that is not reasonably necessary for support. As stated by one court:

Most courts include the debtor's spouse's income in the budget for purposes of calculating projected disposable income under §1325(b) notwithstanding that the spouse is not a debtor in the Chapter 13 case. The theory is that the nonfiling spouse's income is available to defray the debtor's reasonably necessary expenses, thus freeing a larger portion of the debtor's separate income for satisfaction of unsecured claims. Creditors have argued successfully that it would be unfair to allow the debtor's separate income to be used for the family necessities and not count a nonfiling spouse's income which would remain "disposable" to the debtor and uncommitted to the plan.

This view recognizes the reality that married couples live as a unit, pooling their income and expenses. This reality is also reflected in the Official Bankruptcy Forms which require a married debtor in Chapter 13 to report the income and expenses of herself and her spouse. Official Form No. 6, Schedules "I" & "J." The Official Forms, moreover, are mandatory for debtors to follow pursuant to Bankruptcy Rule 1007(b)(1) which instructs debtors to file a schedule of income and expenditures as prescribed by the Forms. F.R.B.P. 1007(b)(1).

Turning to the present case, then, it is evident that the Debtor's plan is not yet ready for confirmation. The Debtor has not satisfied her burden of demonstrating that all of her projected disposable income is being committed to the plan. Without income and expense information from the Debtor's husband we are unable to make a determination of the Debtor's disposable income. If Mr. Carter's income is as large as it is alleged to be, it may be that Debtor's basic needs are satisfied therefrom, thus freeing a larger portion of her own money for use in the plan. In any event, we are unable to render a judgment on this issue until all of the information is provided. The schedules as presently filed are misleading, giving the impression that the Debtor, with a monthly income of only $600, is impecunious when in fact she may enjoy a lifestyle of considerable comfort. While the
instructions on the schedules unambiguously require that income and expense information be included for a nonfiling spouse, we will assume for the purpose of this decision that the Debtor's omission of material information was based on a misunderstanding of her obligations and not a reflection of bad faith on her part. Honesty and full disclosure are the most basic hallmarks of good faith. Good faith also requires the Debtor to rethink her proposed plan to the extent she may have had an unreasonably narrow view of the disposable income required to be dedicated to a Chapter 13 plan. This is especially so where, as here, the Debtor's husband stands to benefit substantially from the Debtor's bankruptcy filing. The filing will have the effect of converting a joint debt, for which all of the Carters' jointly owned property is liable, to a debt owed only by the husband. In the latter instance, all of the Carters' entirety property, such as their house, will be immune from execution. It is, thus, fair and equitable for Mr. Carter's income and expenditures to be included in the schedules and have an effect upon the level of payment expected from the Debtor in order to achieve confirmation.

CONCLUSION

For the reasons stated above, confirmation of the Debtor's plan is denied without prejudice.

Even if the income portion of the calculation is clear, there remains the question of what expenses can be deducted as "reasonably necessary." Payments required to satisfy the secured creditors and the priority creditors are usually deducted from the debtor's income, and then the court reviews the debtor's proposed expenses to determine which ones are "reasonably necessary." The following case illustrates some of the inquiries courts may make.

IN THE MATTER OF WYANT

John C. MINAHAN, Jr., Bankruptcy Judge.

This case is before the court to consider confirmation of the debtor's Amended Plan, Debtor's Counsel's Application for Attorney Fees, and the Resistance by the Chapter 13 Trustee. The plan is not confirmed, the debtor shall file an amended plan within 21 days hereof.

The amended plan is not confirmed because the debtor does not propose to pay disposable income to the trustee as required by §1325(b)(1)(B).

This has become a complex case. The complexities are attributable to the debtor's attempt to preserve assets through extensive pre-bankruptcy planning, to manipulate expenses to minimize payments to unsecured creditors, and to provide for the payment of excessive attorney fees.

This case was filed on August 2, 1996. A few days earlier, on July 25, 1996, the debtor borrowed $10,000.00 from his employer and granted a security interest in 6 vehicles, a trailer, a lawnmower and a tractor to secure the loan. On July 31, 1996, the
The debtor purchased an annuity contract for $10,000.00. These transactions resulted in the encumbrance of the motor vehicles and the placement of $10,000.00 in an annuity which is claimed as exempt property.

On June 6, 1996, about 5 weeks before this bankruptcy case was filed, the debtor and Christel Wyant were divorced by a decree of the District Court of Cass County, Nebraska. The debtor appealed the divorce decree to the Nebraska Court of Appeals asserting that the $1,100.00 monthly alimony and pension awarded Ms. Wyant was excessive, that the court improperly awarded a pickup truck to Ms. Wyant, that Mr. Wyant should have been awarded a number of items of personal property, and that when the court allocated the marital property it did not properly consider a lump sum worker's compensation settlement that Ms. Wyant received. On September 24, 1996, Christel Wyant died which terminated the alimony and pension payments. Mr. Wyant has continued to pursue his appeal of the divorce decree in the Nebraska Court of Appeals, although there is now a limited amount in controversy.

Mr. Wyant's original Schedule J, filed August 20, 1996, showed that his projected monthly income was $3,587.13, that his projected monthly expenses were $3,284.00, which included alimony of $1,100.00, and that his excess income was thus $303.13. Mr. Wyant's original Chapter 13 plan proposed payments of $300.00 per month to the Chapter 13 Standing Trustee. After Christel Wyant died, the debtor filed an amended Schedule I which showed that his after-tax income had decreased because his income tax withholding increased by $323.21 per month when he stopped paying alimony. He also filed an amended Schedule J showing that he no longer had an $1,100.00 monthly alimony expense. However, the debtor increased his other monthly expenses by an aggregate of $408.00 per month. Under amended schedules I and J, the debtor has excess income of $858.72, and he proposes to pay $850.00 per month to the Chapter 13 plan.

Considering the debtor's amended schedules, in light of his original schedule J, and the facts and circumstances recited above, I conclude that the increases in projected monthly expenses are attributable to an unwarranted attempt to offset his increase in income, and that the increase in expenses is not reasonable. Some of the increased expenses are for sums which are certain, such as an increase from $497.00 to $505.00 to reflect the correct amount of the debtor's mortgage payment. Such an increase is appropriate. However, the majority of the increase is for items that are discretionary in nature. It is not necessary for the debtor to make these increased expenditures in order to maintain himself and his dependents. Three hundred seventy-five dollars ($375.00) of the increase in monthly expenditures after the discontinuance of his alimony obligation is disallowed.

I further conclude that the debtor's proposed expenditures on veterinary expenses and livestock feed are unreasonable. The debtor is in the unfortunate position of owning several horses and dogs, which are elderly and which require extraordinary veterinary expenses. It is commendable that the debtor is willing to care for these animals and to attend to their feed and medical needs. On the other hand, this is a bankruptcy case in which the debtor is seeking to be discharged from his obligations to pay creditors. As between the debtor's elderly horses and dogs and his creditors, I think that the creditors should be paid first. The proposed expenditures on these animals are excessive, unreasonable, and not necessary for the maintenance or support of the debtor or his dependents.

On the other hand, the debtor should be encouraged to proceed in Chapter 13 in order that his creditors will receive payments over time. The disposable income analysis should not be so strict as to deprive the debtor of all discretionary income.
Accordingly, I conclude that it is appropriate for the debtor to expend $100.00 per month for feed and veterinary expenses. This means that the proposed payments under the plan shall be increased and that for the 36 months of the plan, the debtor shall pay the trustee $1,300.00 per month. This sum represents proposed payments of $850.00 a month, plus disallowed expenses of $450.00 ($375.00 plus $75.00). . . .

By separate order, the proposed Amended Plan is not confirmed, the Chapter 13 Trustee's Objection to Confirmation is sustained, and the Application for Attorney Fees is denied.

Was confirmation at the Pet Cemetery? Did the Visa representative volunteer to waive in favor of Rover? Is Mr. Wyant a cynical manipulator or a man struggling as he loses the core pieces of his life? Judges are thus forced into intensely personal moral decisions by a provision that appears merely financial.

The disputes over what debtors may and may not deduct from their income under the 1984 Amendments’ reasonably necessary test reveal a staggering array of choices. A case that communicates the flavor of the kinds of decisions the court must make is Univest-Coppel Village, Ltd. v. Nelson, 204 B.R. 497 (E.D. Tex. 1996). Mr. and Mrs. Nelson paid $395 a month to keep their 15-year-old daughter in Liberty Christian School. When they filed for Chapter 13, one of their creditors objected to the expense, saying that this money should be counted as disposable income. Dad pointed out that the girl was "adamant" about not changing schools, and, in what he thought would be the clincher argument, he noted that she was the "only freshman to make the cheerleading squad." The bankruptcy court allowed the expense, but the district court said no, send the kid to public school. We wondered if there would be a protest from the pom pom crowd.

ii. Above-Median Debtors

As noted earlier, debtors with incomes above their state median are required to propose five-year plans. Their lawyers must also determine if these debtors have a surplus of income calculated according to the presumptive-abuse test of section 707(b)(2)(A)-(B).

If the debtors have a surplus of income under the means test, section 1325(b)(3) requires that they pay unsecured nonpriority creditors an amount equal to that surplus over the sixty months of their plan. That is, the statute in effect establishes their Chapter 13 expense budget at the IRS guidelines level, as modified by the Bankruptcy Code under sections 101(10A) and 707(b)(2)(A)-(B). In effect, the debtors are permitted the same expense allowances they had in the means test. In Chapter 13 they have to write a check to their Chapter 13 trustee every month for the difference between their income and those allowed expenses.

If the debtors are above the median but do not have a surplus according to the presumptive abuse test, it appears they are treated like the below-median debtors for determining how much to pay. That is, they must pay over five years whatever is required by application of the 1984 disposable income test as elaborated by the case law
in each circuit and district. §1325(b)(2). Like their above-median counterparts with statutorily-defined surplus income, they will be sending a check to their Chapter 13 trustees, but the amount will be determined by a different test.

The implications of using different tests may not be exactly what Congress had in mind. An above-median debtor with $75 per month surplus is not required to use the IRS guidelines for expenses. (Recall that the presumptive-abuse test applies only if the defined surplus is at least $6,000, which is $100 per month for sixty months. See p. 55.) Instead, that debtor must promise to pay unsecured nonpriority creditors over five years whatever amount equals income minus reasonably necessary expenses. That excess could be considerably more or considerably less than $75 per month. The above-median, no-surplus debtor may have a powerful incentive to file in Chapter 7 to avoid having to complete a five-year plan, so long as no other provision in the law pushes him toward Chapter 13.

On the other side, the Chapter 13 debtor with above-median income and a $125 surplus seems to get a different kind of bonus: the amount that that debtor pays is limited to the means-test surplus. The protection of secured debt can sop up a great deal of income, as the above-median debtor continues to pay the big house payment and big car payments after filing for Chapter 13, leaving only a modest amount for the unsecured creditors. §1325(b)(3). By substituting the automated features of the means test, the 2005 Amendments once again oust the court from its discretionary role. Instead, that discretion—making people count a non-filing spouse’s income or giving up a pricy car, for example—is reserved for below-median income debtors and for above-median income debtors who have no surplus debt. Bankruptcy has always had a bit of a Wonderland flavor, but Alice might have seen the 2005 bankruptcy revisions as a surprising new path to the rabbit hole.

Section 1325(b)(2) establishes additional deductions for domestic support payments (for example, child support) and certain charitable contributions, both items that may overlap with the deductions allowed under the current-income and presumptive-abuse tests. It also permits deduction of the costs of doing business for those debtors who continue to operate their businesses.

b. Competition among Creditors

The Wyant case illustrates the creditor-versus-creditor aspect of bankruptcy. The trustee challenged Mr. Wyant's veterinary bills, and we wondered if the trustee might also have joined Mr. Wyant in his challenge to the ex-wife's alimony — if she had survived. For every dollar that did not go to Mrs. Wyant, there would presumably be another dollar for distribution to the unsecured creditors. That certainly gives another cast to the divorce proceedings.

The previous two sections of this chapter focused on the amount to be paid to secured creditors. While the secured creditor wants every penny of what it can collect as payment of its claim, the trustee as representative of the unsecured creditors may press to reduce those payments. The interrelated nature of Chapter 13 payments is sharply illustrated by the 2005 Amendments’ requiring full payment to undersecured creditors whose security interests were granted in the recent past, as discussed above. During the debates on these provisions, a group of Chapter 13 trustees examined their records to determine the effects of the that provision as it related to automobile lenders alone. The study reported that adoption of full payment for all auto loans would mean about one in
five (20.79 percent) of existing Chapter 13 cases could not be confirmed at all and nearly half of the cases (44.78 percent) would be confirmed with a substantial reduction in distributions to general unsecured creditors. This conclusion suggests that the 2005 provisions favoring secured creditors will substantially reduce the opportunities for repayment of unsecured creditors through Chapter 13. The data are a grim reminder that because the debtors in Chapter 13 often have modest incomes, a dollar that goes to one creditor is a dollar less for another. It is a simple but arresting instance of the general truth that bankruptcy policy is not a simple debtor versus creditor affair, but involves substantial conflicts among creditors (and other interested parties) as well, a point that we will discuss further in the business bankruptcy materials.

c. Family Support, Taxes, and Other Priority Claims in Chapter 13

The third leg of the repayment scheme in Chapter 13 is the special set of rules for repaying priority creditors. As we noted in the preceding section, creditors with claims that would receive a priority under section 507(a) are entitled to payment in full in Chapter 13. §1322(a)(2). Many debtors owe no priority repayments. For them, Chapter 13 is defined by the required treatment of secured and unsecured creditors. But some debtors are obligated to pay debts that would qualify as section 507(a) priorities and must therefore adjust their plans to account for these obligations.

i. Priority Repayments in General

Some debtors pay section 507(a) administrative expenses in their Chapter 13 plans. A debtor who did not have enough cash to pay the filing fee, for example, may pay the filing fee as a priority repayment in Chapter 13. (Under Bankruptcy Rule 1006(b), the filing fee must be paid within 120 days of filing, which means that the filing fee is to be paid in installments in the first four post-filing payments.) Similarly, some debtors pay their attorneys in Chapter 13, although practices on this vary widely from jurisdiction to jurisdiction. Some courts hold that because the attorney's services are rendered pre-petition and do not benefit the estate, they cannot be paid in Chapter 13. Other courts see the attorney's work as creating the estate and therefore entitled to repayment in full as a priority in Chapter 13. Once a court's views are known on this subject, local practice can be expected to adjust, requiring payment up front or payment in installments as a function of what the courts will permit.

Many debtors, like Mr. Wyant in the preceding section, owe alimony or child support at the time of their filing. Because those obligations are entitled to priority repayment in section 507(a)(1), they also enjoy full repayment priority in Chapter 13. §1322(a)(2). Indeed, many Chapter 13 trustees point with pride to an unexpected benefit of having an ex-spouse in bankruptcy: The trustee will take over the function of collecting child support and distributing it to the intended recipients. Trustees frequently use wage orders so that money is diverted directly from the employer to the trustee. Although a support recipient could seek a garnishment order outside bankruptcy, some recipients are glad to have a trustee in bankruptcy take care of the matter and supervise the payments on their behalf. Moreover, the bankrupt ex-spouse who owes support obligations may face a different set of incentives after a bankruptcy filing. Failure to make payments will
involve potential dismissal of the Chapter 13 case, which can mean loss of a car or resumption of various other creditor collection actions; the option of paying everyone else and stiffing the ex will no longer be available. A debtor who continues plan payments will, by necessity, have to be current on all support obligations.

Because repayment in full of all priority debts is a requirement for confirmation of the plan, priority creditors are no longer placed in the competitive position they sometimes suffer in Chapter 7. Each and every priority debt must be paid in full, unless the party entitled to repayment waives this right. In addition, the debtor must pay secured creditors the full amount to which they are entitled. If the debtor cannot pay, the plan cannot be confirmed. Disposable income is a floor—a minimum amount that a debtor must pay. It does not act as a cap on the total a debtor must pay. If, for example, a debtor does not have enough money to pay his house payment, his allowed secured claim on his car, his outstanding administrative expenses, his child support, and have enough left to live on, then he cannot confirm a Chapter 13 plan. In such a case a debtor may want to consider giving up some of his property that is collateral for the secured debt obligations, and thus reducing the level of payments required in a Chapter 13. Alternatively, the debtor may file for Chapter 7.

ii. Tax Claims

In addition to administrative and support claims, consumer debtors may face substantial tax claims. Because taxes are nondischargeable, a debtor with a tax problem rarely receives much direct relief in his dealings with the taxing authorities from a Chapter 7 filing, but Chapter 13 offers two advantages. One is paying the taxes over time, with the automatic stay holding off the IRS. (Remember the stay lasts until discharge, which in Chapter 13 isn’t until the plan is completed. §362(c)(2)(C).) Second, the denial of post-petition interest on unsecured claims will lock the tax claim at its value as of the date of the bankruptcy filing. §502(b)(2). We have already covered this point, but it bears repeating here. Stopping the relentless accrual of interest may be the only way the taxpayer has a chance to catch up on what he owes. For some, the chance to pay off the taxes over time without interest is the principal motivation for a Chapter 13 filing.

If the debtor gets into bankruptcy before the IRS files a lien, the tax claims will be unsecured. Similarly, if the tax claim exceeds the value of the lien or if the lien secures some taxes but not others, there will be an unsecured tax claim as well. The automatic stay will prevent the IRS from taking any further collection actions — including securing a new lien on the debtor’s property.

Once the priority tax claim is determined by reference to section 507(a)(8), the debtor can then work out a plan for regular payments. Priority claims, unlike allowed secured claims, are not paid in present value dollars. Instead, the debtor is required to pay the nominal amount of the claim, without interest. The language in section 1325(a)(4) and (a)(5) requires payment to unsecured and secured creditors based on "the value, as of the effective date of the plan," which the courts uniformly understand to mean present value or interest. But the language in section 1322(a)(2) governing the payment of priority debt refers only to "full payment, in deferred cash payments," an amount the courts have determined does not include interest. See, e.g., In re Pitt, 240 B.R. 908 (N.D. Cal. 1999), discussing Bruning v. United States, 376 U.S. 358 (1964) and In re Pardee, 218 B.R. 916 (9th Cir. BAP 1998). This means that when the interest payments on tax
debts stop at the time of filing, they really stop—they do not recommence under a present value analysis in the Chapter 13 plan.

The interconnected nature of the Bankruptcy Code comes into sharper relief with a review of dischargeability. The Chapter 13 debtor ultimately hopes to discharge all the unpaid debts at the conclusion of the plan. This provides a neat set of bookends for the debtor with tax troubles: At one end is repayment in full for all taxes subject to a lien under section 506(a) or entitled to a priority under section 507(a)(8) and an explicit requirement in Chapter 13 to pay these claims ahead of all other claims; at the other end is the discharge of most of the remaining taxes and all other dischargeable debt. By the operation of these combined provisions, a debtor in trouble with the taxing authorities may have a way out.

d. Good Faith

The construction of a Chapter 13 plan begins with dividing up the debtor's income among necessary expenses and payments to secured creditors. After this division is made there is sometimes nothing left. Can a debtor confirm a plan that pays nothing to the general unsecured creditors? Or, to ask the question another way, if all the debtor's disposable income has been used up, can Chapter 13 be used merely to restructure secured debt without making some provision for the unsecured creditors?

To parse out an answer, it is necessary to sift back through the multiple versions of the Code. (We know you just want to cut to the answer, but the problem is that no one knows the answer for sure, so we’re stuck with working through the reasoning.) The best interests test was the only explicit statutory requirement for plan payments to unsecured creditors in the 1978 Code. Because so many consumer cases would have been "no asset" cases in which creditors would get nothing in a Chapter 7, the best interests test provided no floor on the amount that debtors would be required to pay. In response to debtor plans proposing to pay little or nothing to unsecured creditors, some courts developed a "good faith" test to force a higher level of payments. When the new disposable income test was added in the 1984 Amendments, these courts had to determine whether there remained a good faith review that could be used to toss out a debtor who proposed a low-payment plan that otherwise satisfied the disposable-income test.

Prior to the 2005 Amendments, the courts divided on this issue. Some said the disposable-income test had pre-empted cases that used a lack of good faith as a ground for rejecting plans that paid too little to the general unsecured creditors. Others argued that minimal payment could still be used as one element in a “totality of circumstances” test for good faith if other facts suggested abuse of the bankruptcy system. As we have seen, the 2005 Amendments have gone much further in defining disposable income and abuse, and have retained the totality test only as an alternative where the presumptive-abuse doctrine does not apply. §707(b)(2)(B), (3). Those changes may or may not persuade the courts that they should continue to apply an additional, ad hoc standard of good faith, especially in the cases involving below-median debtors to whom the presumptive-abuse standard does not apply (once again with the ironic twist that it may be the lowest-income debtors who get hit with the harshest standards).
The following case is one example of the impact of the good faith issue under the pre-2005 disposable-income standard.

In re LEONE

WARREN W. BENTZ, Bankruptcy Judge.

FACTS

Debtors own real property located at 4308 Alison Avenue, Erie, Pennsylvania, which serves as their principal residence (the "Property"). The Property is valued at $138,380.

U.S. Bank, N.A. as Trustee ("US Bank") holds a first mortgage secured by the Property with a balance of $205,796. The Plan provides for the Debtors to keep the Property valued at $138,380, cure arrearages of $18,957 to U.S. Bank, and to continue regular monthly payments of $1,325.58 which will result in a cure and reinstatement of the U.S. Bank mortgage. In other words, Debtors propose to maintain and pay the principal balance of $205,796 over time for the Property which is valued at no more than $138,380. The Plan also proposes full payment of delinquent real estate taxes in the amount of $6792.79 plus interest.

The Debtors have two vehicles. Debtors have modified the balance due to the lenders on the vehicles under §506 and propose to pay the modified balances in full over the 36 month term of the Plan.

The Plan provides that Debtors will pay $2,850 per month for 36 months. Unsecured creditors will receive a dividend of approximately 11%. Debtors contemplate a monthly housing expense of $2,347.88 [including mortgage payment, insurance, maintenance, and so on].

Debtors list as dependents on Schedule I a 21 year old son and an 18 year old daughter.

ISSUE

The issue which the Court raises sua sponte is whether it is appropriate to confirm a 36 month Plan of reorganization where Debtors seek to pay $205,264 plus delinquent real estate taxes for a house admittedly worth $138,380 with a total monthly housing expense of $2,347.88 when unsecured creditors receive a dividend of 11%.

DISCUSSION

The Bankruptcy Code requires that a Chapter 13 Plan be proposed in good faith. §1325(a)(3). Whether a plan is filed in good faith is a question of fact based on the totality of the circumstances. In re Smith, 286 F.3d at 466; See also In re PPI Enterprises (U.S.), Inc., 324 F.3d 197, 211 (3d Cir.2003) (In considering the good faith requirements in a Chapter 11 filing context, the court states that there is no list that is
exhaustive of all the factors which could be relevant when analyzing a particular debtor's good faith.

"There is no requirement per se that a Chapter 13 Plan provide for substantial repayment of unsecured creditors." In re Hines, 723 F.2d 333 (3d Cir.1983). Plans are routinely confirmed by this Court and others where debtors lack an ability to provide unsecured creditors with a significant distribution. In re Rice, 72 B.R. 311 (D.Del.1987) (and cases cited therein).

Here, the Debtors have an ability to make significant distributions to unsecured creditors. A good faith effort would require that Debtors find replacement housing for themselves and their two adult children at a cost of less than $2,347 per month, or it may require that Debtors give up the idea of paying more than $205,000 for a $138,000 house; neither of which would impose a significant burden. If Debtors elect to maintain their Property, it is they that should bear the cost of the unusual and improvident expenses which unfairly discriminate against unsecured creditors. As an alternative, the Debtors could elect to extend the payments under their Plan for a term of up to 60 months. We are unable to find that the proposed Plan is filed in good faith.

Confirmation of the Plan will be refused.

The 2005 Amendments removed secured debt entirely from the calculation of income and expense, possibly overruling cases like this one on the argument that Congress now intends that all secured debt be paid before any consideration of the required payments to unsecured creditors. §§1325(b)(1)(2); 707(b)(2)(A(i), (iii). Moreover, the 2005 Amendments evidently contemplate the confirmation of some plans that will leave nothing for the general unsecured creditors. Section 1322(a)(4) permits a plan to be confirmed without paying all the priority debts only if all disposable income has been dedicated to that task; if all disposable income is going to the priority claimants, there is nothing left for the general unsecured creditors, which suggests that a zero-payment plan is acceptable.

Unsecured creditors may complain that the debtor who is giving them little or no payments, but instead diverting substantial amounts to secured creditors or to pay off priority debts, is not in good faith, but it seems that Congress had in mind to confirm such plans. Once again, we may see the unintended consequences of promising protection to a variety of interest groups. Here the promises to security and priority creditors may mean there is nothing left for the unsecured creditors.

e. Modification and Dismissal of Chapter 13 Plans

A Chapter 7 liquidation involves only the liquidation of already-acquired assets. By contrast, a Chapter 13 plan relies on projections of future income and living expenses to extrapolate the amount the debtor can pay. Often debtors in Chapter 13 bankruptcies already have had significant financial disruptions, and these projections of income and expenses frequently are not borne out. When that occurs, the debtor or the creditor may move to have the plan modified or dismissed. §1329(a). Most often, the debtor is seeking modification because of a lost job or other event that has made payment of the originally promised amounts much more difficult. The 2005
Amendments specifically permit a modification to permit the debtor to purchase health insurance. §1329(a)(4).

Modification hits another bump—the statutory limits on the length of a plan. The Bankruptcy Code limits any Chapter 13 plan to a maximum of 60 months. §1322(d)(1). When a plan is modified, it must still meet all the Chapter 13 requirements, including the five-year limit. When the 2005 Amendments required that all above-median-income debtors file 60-month plans, they wiped out any flexibility in reworking plans when the debtor fell behind. For an above-median-income debtor who loses a job or otherwise stumbles in trying to repay, the two sides of the trash compactor now touch—the plan may not be longer than 60 months nor shorter than 60 months, which means the debtor has to find a way to make up for the missed payments despite an income for which all spare change has already been fully committed.

Not all new events are bad events. Some debtors will get a raise, work a little overtime, or sell the car. But the good news may be short lived for the debtor. Instead, creditors or the trustee are allowed to trumpet good news for the debtor and to argue that the plan should be modified to permit higher payments. Creditor demands for modification may become more common because the 2005 Amendments require the debtor to file annual financial updates if the judge or any party in interest requests them. The update must describe the debtor’s income and expenditures for the last tax year—under penalties of perjury. (How many law students or their teachers could produce such a document?) §521(f)(4). Thus creditors can discover any monetary joy that has touched the debtor’s life and ask to take it all. Because the debtor is already in “disposable income” territory, any new income would seem to flow directly to the creditors.

Problem Set 15

15.1. You are filing your first Chapter 13 plan since entering practice. In your jurisdiction, judges are randomly assigned as cases are filed. The three bankruptcy judges seem to have rather different views about the requirements for confirmation of a Chapter 13 plan—two are very strict and one is quite lenient. All three permit the debtor to amend if a plan is not confirmed. Your first client, Maria Jackson, is a single parent who supports herself and three children on the salary she earns as a department store clerk in Atlanta. Ms. Jackson earns $23,000 a year. She is left with $60 per week after she has paid her rent, utilities, insurance, food, gas, and $10 each Sunday to her church. This amount would give her creditors about 50 percent of their outstanding debt over three years or 80 percent over five, but it would not leave any cushion. Giving $60 to the trustee would also require termination of the piano lessons one child has already begun and prevent another child from starting needed orthodontic treatment. What kind of a plan do you propose for her? Does your malpractice insurer have an opinion on what you should do? See §§1322, 1325, 1329; IRS Expense Guidelines.

15.2. A. You represent Todd Cooper, a fast food store manager in Orlando. With incentive bonuses and income from his accumulated stock, Todd's total income is slightly over $150,000. Todd lives as if it were even higher. He has a home with a mortgage larger than the annual income of some Third World nations, three cars on which he owes
more than most people owe on their homes, two children in private school, and so on. In short, after he pays all these fixed expenses, plus a reasonable amount for food and clothing, he has about $30 per week for his unsecured creditors in his Chapter 13 plan. He owes these creditors almost $95,000. His total three-year payout at $30 per week will be $4,680, about 3 percent of his debt. Because most of his assets are subject to heavy liens and his state has generous exemptions, the unsecured creditors would get nothing in Chapter 7. Can you get Todd's plan confirmed? What are the weaknesses in your case? See §1325.

B. In an alternative universe you represent two of Todd's creditors, Perfection Motors, the Mercedes dealer who holds a $35,000 PMSI on one of his cars, and Divine Cuisine, his caterer, who is owed $5,600 for a series of business receptions Todd gave for bosses and coworkers in the fast-food chain. What position will you take regarding Todd's plan?

15.3. Christopher Paulus got his engineering degree from the University of Illinois and is doing well working for a worldwide construction firm. He earns over $60,000 per year. He lives in a nice apartment in Chicago with his girlfriend Frieda, who works as a physical therapist and shares the rent and other household expenses. When he first got out of college he went a little nuts with his credit cards and is carrying a $40,000 credit card debt. However, he has settled down and until recently was steadily reducing the debt by living frugally, driving the old family car his parents gave him, eating at home, shopping at Costco, and so on. Unfortunately, his elderly dad got very ill and even with Medicare payments had substantial out-of-pocket medical expenses. Chris co-signed for the necessary charges to the day his dad died and now finds himself with $60,000 in medical debt in addition to the credit cards, so he is contemplating some form of bankruptcy filing. Chris wants to know what his options are. Tell him what other information you need to know in order to answer his question. §1325.

15.4. Rebecca Nordhaus is a nurse who is rearing a small son while she works in a metropolitan trauma center. She was already carrying too much consumer debt when a serious car accident left her with more than $60,000 in bills that were not covered by insurance. Last year her base salary was $33,000, which would yield about $400 a month in disposable income, but her pay with overtime was $45,152. She says the overtime is exhausting her and she wants to spend more time with her son. What do you list for her disposable income in her Chapter 13 plan? See §1325(b).

15.5. You are completing preparation of a Chapter 13 plan for Jason D'Angelis. He wants to file but his wife, who is not employed outside the home, does not. Their income is $45,000. After you have computed his expenses, it appears that he will have about $425 a month that would be available for distribution to his creditors. Mr. D is very reluctant to pay anyone, and he keeps asking if he can't claim some more expenses. Finally, he looks at the expense list and says, "I want to make contributions to my church." You ask the amount, and he says, "$425 a month." You ask if he has made regular contributions in the past, and he says "No, but I'm turning over a new leaf." Can Mr. D confirm a plan that pays nothing to his unsecured creditors? What do you advise him? §1325(b)(2)(A)(ii).

15.6. Last year you represented Doris Frankel in her Chapter 13 bankruptcy. You regard it as one of your most satisfying cases. When you met Doris she was a recently widowed, middle-aged woman who had never worked outside the home. At her husband's death, she was left with huge bills incurred during his final illness and a load of debts from his business for which she was jointly liable. After she used all the insurance and sold the business, she was still $120,000 in debt. Her creditors included
some hostile and aggressive former business partners of her deceased husband. Doris took a job as a clerk at the local Mega-Lo-Mart, and she asked for your help in keeping her creditors from taking everything she and her husband had built up.

You took her into a Chapter 13, and she insisted on a 25 percent repayment of her unsecured debt. You thought that amount was too high and that she would have nothing left over, but she said it was important to her self-esteem.

Today, Doris is back in your office. She hardly looks like the same woman. While she worked at the Mega-Lo-Mart and another part-time, evening job, she began real estate classes. She has passed her exams, quit her other jobs, and has been selling commercial real estate for four months.

She has come to share some wonderful news with you. Last night she got a call from a well-known real estate developer. It seems that he had met Doris and liked her quiet, sincere style. He checked her background and decided she was just the woman he wanted to be in charge of the completion and leasing of his latest office building. She recognizes the enormous work that she will have to do. She must supervise all finishing work, find tenants, negotiate leasing arrangements and customizing work, etc. Doris estimates that she will be working 60 hours a week, at least. But if she can pull it off, the bonuses for 95 percent leasing in the first year could be as much as $50,000. You are delighted for her, but do you have any free advice? See §1329.

B. THRESHOLD ELIGIBILITY FOR CHAPTER 13

Section 109(e) limits access to Chapter 13 to natural persons with limited debts and regular income. Congress may want more debtors in Chapter 13, but sometimes a creditor would rather deal with the debtor either under state law or in Chapter 7. In that case, the creditor may contest Chapter 13 eligibility. The following case illustrates the liberal attitude of many courts on letting people who want to try a Chapter 13 repayment to have their chance. Some judges, however, might not go as far as Judge Lundin, a widely acknowledged expert in Chapter 13 law.

In re MURPHY


Keith M. LUNDIN, Bankruptcy Judge.

I

For 11 years, the Debtor has shared a household with Sam Hambrick. The home is owned by Mr. Hambrick and his elderly mother.

Mr. Hambrick's twin daughters (now 16 years old) live with the Debtor and Mr. Hambrick and have been raised by the Debtor. One of the twins has asthma and needs
special medical attention. The Debtor also takes care of Mr. Hambrick's and her own elderly parents.

Mr. Hambrick is a self-employed businessman. He nets $3,800 per month from his businesses. At times during the past 11 years, the Debtor worked at a market owned by Mr. Hambrick. The market closed two or three years ago and the Debtor has not worked outside the home since then.

Throughout their relationship, Mr. Hambrick has deposited money into the Debtor's bank account each month from which the Debtor pays her separate bills. Mr. Hambrick pays all of the utilities and other household expenses for "their family" and typically deposits $800 a month into the Debtor's account.

The Debtor owns a 1994 Cadillac. The monthly installment note on this car was paid before bankruptcy from the bank account funded by Mr. Hambrick. At the petition, the holder of this note, First Indiana National Bank, was owed $5,700. The car was scheduled by the Debtor with a value of $14,750.

In July of 1998, Constance Morris took a default judgment against the Debtor in the General Sessions Court for Davidson County, Tennessee for $15,000. Ms. Morris executed on this judgment during the first week of August 1998 and the sheriff seized the Debtor's 1994 Cadillac. This Chapter 13 case was filed on August 12, 1998, after seizure but before sale of the car to satisfy the judgment. The statements and schedules show current income and expenses of the Debtor's household with Mr. Hambrick. Attached to the schedules is an "affidavit of Samuel Hambrick" which recites "I hereby agree to make [Brenda Jean Murphy's] Chapter 13 plan payment on her behalf, in a timely manner, and in the court order amounts, until completion of the plan."

Under the proposed plan, the Chapter 13 trustee will receive $600 per month for three years. The first lien holder on the car will be paid in full with interest. Constance Morris is treated as a partially secured creditor and the plan provides that the Debtor will avoid the judicial lien "to extent of $4,000 exemption." The portion of Ms. Morris's lien that remains after lien avoidance will be paid in full with interest. Unsecured creditors will receive at least 20% on allowed claims.

The Debtor filed a motion to partially avoid the Morris lien and a motion for turnover of the 1994 Cadillac. Ms. Morris objected arguing that the Debtor is not eligible for Chapter 13 because the Debtor does not have "regular income" as required by 11 U.S.C. §§109(e) and 101(30). . .

II . . .

That §101(30) defines individual with regular income by reference to stability and regularity suggests that the existence of regular income is predominantly a fact question answered by examining the flow of money available to the debtor. Put another way, the Bankruptcy Code does not specifically exclude any source of funding from the regular income calculus; the Code does require that whatever source of income is claimed by a debtor, it must be regular and stable enough to fund a plan. The stable and regular focus of §101(30) has led several courts to state that "the test for 'regular income' is not the type or source of income, but rather its regularity and stability."

If the monthly contribution of money committed by Mr. Hambrick to the Debtor is income, the facts overwhelmingly support the finding that this Debtor's income is
sufficiently regular and stable to fund a Chapter 13 plan. For 11 years Mr. Hambrick has maintained unbroken financial support to the Debtor. The Debtor has raised Mr. Hambrick's twin daughters and taken care of Mr. Hambrick's elderly parent while maintaining a home for herself, Mr. Hambrick, and Mr. Hambrick's children. Mr. Hambrick's income is substantial and regular and for many years has produced at least the amount he has committed to funding this plan. The expenses in the budget for the Debtor and Mr. Hambrick are comprehensive, modest and appropriate. Mr. Hambrick has signed an unconditional written commitment to provide the Debtor with money sufficient to fund the proposed Chapter 13 plan. Mr. Hambrick was forthright and honest in his testimony. Both Mr. Hambrick and the Debtor presented undisputed and convincing evidence of their commitment to each other and to their collective family and of their intent and ability to fund a Chapter 13 plan.

If Congress intended the word "income" in §101(30) to exclude the money Mr. Hambrick will pay to the Debtor, that less inclusive definition is not apparent in the Bankruptcy Code or its legislative history. The Code easily could but does not restrict the notion of income to wages, salary, return on investment or any of the other restrictions suggested in reported cases. The legislative history of what is now 11 U.S.C. §101(30) is unusually clear that Congress intended to expand and broadly define "individual with regular income" to include funding from diverse and nontraditional sources. As explained in the Senate Report:

Paragraph [(30)] defines "individual with regular income." The effect of this definition, and of its use in section 109(e), is to expand substantially the kinds of individuals that are eligible for relief under chapter 13, Adjustment of Debts of an Individual with Regular Income. Chapter XIII is now available only for wage earners. The definition encompasses all individuals with incomes that are sufficiently stable and regular to enable them to make payments under a chapter 13 plan. Thus, individuals on welfare, social security, fixed pension incomes, or who live on investment incomes, will be able to work out repayment plans with their creditors rather than being forced into straight bankruptcy. Also, self-employed individuals will be eligible to use chapter 13 if they have regular incomes.


Some courts have narrowed the definition of income for §101(30) purposes by requiring that the debtor have a "legal right" to the funding or that the source have a "legal duty" to make payments to the debtor. In cases involving contributions by a significant other of the debtor, some decisions use the absence of a "legal duty of support" as the basis for finding the debtor ineligible.

What does legal duty or legal right mean in this context? By statute or common law spouses, for example, have a mutual duty or right of support. But the absence of similar law with respect to the support obligations of unmarried couples hardly proves the absence of income for §101(30) purposes. In states like Tennessee, in the absence of a contrary contract or overriding public interest, an employer has the right to fire an employee at will and without cause. There is no "legal right" in Tennessee to continued employment — it depends on the pleasure of the employer, the quality of a debtor's work, the success of the employer's business, the weather, the economy in Asia — conditions to a debtor's right to wages that are in many ways less within a debtor's control than this Debtor's relationship to Mr. Hambrick. Yet, no one would seriously contend that the money a debtor expects to receive from employment is not income for §101(30) purposes
just because the debtor has no legal right to continued employment. A definition of income for Chapter 13 eligibility purposes cannot be bottomed alone on the presence or absence of statutory or common law support obligations.

Maybe these courts mean that there is income only if a debtor has a remedy through the courts if payments stop. This notion is also too narrow for §101(30) purposes. Entitlements such as welfare and social security are income for eligibility purposes in a Chapter 13 case yet such benefit programs can be limited or abolished at the will of the legislature. And once (constitutionally) altered by the legislature, there is no recourse through the courts to force the payment of benefits.

Mr. Hambrick could employ the Debtor to take care of his twin teenagers and that employment would most likely be found to produce income for §101(30) purposes. In Tennessee, Mr. Hambrick could also fire the Debtor from that employment at any time, with or without cause. Mr. Hambrick's written promise to fund this Chapter 13 plan coupled with Mr. Hambrick's convincing testimonial commitments is at least as formal and concrete as legislative largess in a welfare program or as an employer's promises of work in the typical Chapter 13 case.

Mr. Hambrick's promise to fund this plan together with continued performance by this Debtor may generate rights and obligations that are every bit as enforceable as an employment contract. Reported decisions from many jurisdictions confirm that on theories of unjust enrichment, quantum meruit, restitution and express or implied contract, unmarried individuals sharing a household have successfully enforced financial commitments by their significant others. These cases are not based on marital support obligations found in statutes. Rather, recoveries typically are allowed on contract theories. If there is an amorphous requirement of legal rights or legal duties as predicate to a finding of income for §101(30) purposes, such rights and duties are found in the promises and performance by unmarried couples like this Debtor and Mr. Hambrick.

III

The Debtor can use §522(f) to partially avoid the judgment lien of Constance Morris. It is undisputed that the debtor has a $4,000 exemption in the car. The statements and schedules value the car at $14,750. There is a first lien of $5,700. The sum of the first lien and the Debtor's $4,000 exemption is $9,700, resulting in equity in the vehicle of $5,050. . . . The Debtor's lien avoidance right is limited by the $4,000 exemption and the lien remains in place to the extent of value in the car above the sum of the first lien plus the Debtor's exemption.

Lest anyone draw the wrong conclusion about bankruptcy as a haven for those with irregular living arrangements, we hasten to point out that some bankruptcy judges are more traditional. In Montana, the court said that a debtor who had been getting an allowance from her "live-in boyfriend" did not have REGULAR income. In re Duval, 226 B.R. 117 (Bankr. D. Mont. 1998). The fact that he had been paying for ten years did not make it REGULAR income. We begin to suspect that for some courts, "regular" means something other than once-a-month.
Identifying Types of Claims

In the next case, the court addresses the second eligibility requirement for Chapter 13 under section 109(e): that the debtor have noncontingent, unliquidated debts under the statutory maximums. These terms are slippery and even the courts sometimes get them wrong. Note that the debt limits for Chapter 13 have been raised since this case was decided.

In re HUELBIG

ARTHUR N. VOTOLATO, Bankruptcy Judge.

Before the Court is Allstate Insurance Company's (Allstate's) Motion to Dismiss the Huelbigs' Chapter 13 case, on the ground that their unsecured debt exceeds the limits proscribed in 11 U.S.C. §109(e). The Debtors argue that Allstate's claim is unliquidated and therefore may not be counted in determining their eligibility for Chapter 13. For the reasons discussed below, I find, for jurisdictional purposes, that Allstate's claim is noncontingent and liquidated, and should be counted in determining the Debtors' eligibility for Chapter 13. Having said that, the Debtors clearly do not qualify for Chapter 13, and Allstate's Motion to Dismiss is GRANTED.

BACKGROUND

During the early 1990s, Raymond Huelbig operated an auto body repair shop which did business with many insurance companies, including Allstate. In September 1999, Allstate filed a civil complaint in United States District Court in Providence against the Huelbigs and twenty other defendants, alleging Civil RICO violations, including a conspiracy to defraud Allstate out of $337,000 by filing false insurance claims, and on February 20, 2001, Raymond Huelbig plead nolo contendere to certain state criminal charges relating to fraudulent insurance claims. As part of the plea bargain, Huelbig received a ten year suspended sentence, with two years to serve in home confinement, and was ordered to pay restitution to Allstate in the amount of $2,480. On the same date as the plea, the Huelbigs filed a joint Chapter 13 case. During the course of these contentious proceedings, the Debtors have proposed two Chapter 13 plans, to which Allstate objected after conducting lengthy discovery. Allstate also filed a motion for relief from stay and for leave to continue its litigation against the Debtors in District Court.

DISCUSSION

Together with Allstate's claim of $330,505, the Debtors have unsecured debts totaling $357,469. If Allstate's claim is either contingent or, to the extent that it is unliquidated, it would not count towards the Section 109(e) debt limit, and the Debtors would be entitled to proceed in Chapter 13.
"Debt" is defined by the Code as "liability on a claim," and claim is defined as a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured..." 11 U.S.C. §§ 101(12) & 101(5)(A).

While not conceding the issue, the Debtors do not seriously contest that Allstate's debt is noncontingent. The case law uniformly holds that "if all events giving rise to liability occurred prior to the filing of the bankruptcy petition," the debt is not contingent. Here there is no dispute that all events giving rise to the Debtors' liability occurred in the 1990s, well before the petition was filed. The dispositive question is whether the claim is liquidated.

A claim is liquidated if it is subject to "ready determination and precision in computation of the amount due." In re Sylvester, 19 B.R. 671, 673 (9th Cir. BAP 1982), quoting In re Bay Point Corp., 1 B.C.D. 1635 (Bankr.D.N.J.1975). A variety of tests have evolved to ascertain whether a debt is subject to ready determination or is readily calculable. One court has suggested that if a precise computation can be accomplished after a simple hearing, the debt is liquidated; however, if an extensive, contested evidentiary hearing is required, the debt should be treated as unliquidated. The Bankruptcy Appellate Panel for the Eighth Circuit has stated: "The key factor in distinguishing liquidated from unliquidated claims is not the extent of the dispute nor the amount of evidence required to establish the claim, but whether the process for determining the claim is fixed, certain, or otherwise determined by a specific standard." In re Barcal, 213 B.R. 1008, 1014 (8th Cir. BAP 1997) (emphasis in original). Recently, the Ninth Circuit Bankruptcy Appellate Panel clarified its approach, requiring courts to consider the debtor's liability on a debt as part of the process in determining whether a debt is liquidated. Ho v. Dowell (In re Ho), 274 B.R. 867, 872-75 (9th Cir. BAP 2002).

Not surprisingly, the Debtors urge the approach used in Ho, i.e., to consider the issue of the Debtors' liability to determine whether the claim is liquidated. Because they deny liability so loudly, the Debtors argue that an extensive hearing would be required to determine whether Allstate's claim is liquidated. As further proof of the magnitude of this dispute, the Debtors point out, with little relevance, that Allstate's District Court complaint consists of 108 pages, 342 numbered paragraphs, and weighs in at over one pound, even without the voluminous exhibits.

I decline the Debtors' invitation to adopt the 9th Circuit BAP approach and to take into account the issue of liability in determining whether or not this claim is liquidated. Considering liability in this context has been widely criticized, and is followed by only a few courts. A noted Chapter 13 commentator has stated: "Including consideration of disputed liability to determine whether a debt is liquidated is confusing and has been appropriately criticized." K. Lundin, Chapter 13 Bankruptcy, 3d ed. §16.1 at 16-8 (2002). *** Judge Feeney ... concluded that: "the amount of [the creditor's claims] are readily calculable. Therefore, the claims are liquidated regardless of whether the Debtors dispute the liability. This Court specifically rejects the reasoning [that liability should be considered] as it represents a discredited minority view." [In re Mitchell, 255 B.R. 345, 360 (Bankr. D.Mass. 2000)].

Allstate has appended to its proof of claim a list of checks which were funds paid on putative fraudulent claims made by alleged co-conspirators, including the Debtors. While it concedes that liability is vigorously denied, Allstate argues that the dollar amount of its claim may be calculated by simple arithmetic. Following those courts which have so held in similar situations, I also rule here that the claim is liquidated, and that it should be counted in determining the Debtors' eligibility for Chapter 13. See In re
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*Vaughn*, 276 B.R. 323 (Lawsuits were pending in federal district court against the debtor alleging RICO violations, conspiracy, and fraud, based on the debtor's failure to tender rare coins to purchasers after accepting non-refundable deposits. Purchasers were seeking in excess of $600,000 plus treble damages and costs, and the bankruptcy judge found the debt to be liquidated, notwithstanding the fact that the debtor disputed his liability on these claims); *In re Sitarz*, 150 B.R. 710 (Bankr.D.Minn.1993) (Claim for fraud against the debtor is liquidated where a trial exhibit containing false credit card charges and unauthorized checks written by the debtor allowed for simple computation, although the process would be lengthy).

For the foregoing reasons, I find and/or conclude that the Debtors' unsecured debts exceed $269,250, and GRANT Allstate's Motion to Dismiss.1

The court in *Huelbig* gave good explanations of the terms *contingent* and *liquidated*, but a few more examples might be helpful. The clearest case of a contingent claim is a bet in a state where betting creates legally enforceable obligations. If Jay and Liz bet a huge sum on who will win next year's OU-Texas game, in the days before the game both Jay and Liz have a contingent liability. When Oklahoma wins, Jay owes Liz a huge sum and, of course, Liz owes nothing. The point is that until the occurrence of the event — the game — no liability for either party has been established and the claim of either party against the other is contingent. Another example is a negotiable promissory note (like when mom guarantees a car loan for son). When a person indorses a note (mom), the indorser agrees to pay only if the maker of the note (son) does not. The indorser's liability then is contingent. A third example arises when a dealer sells goods with a 30-day warranty. For 30 days, the warranty obligation is contingent. If no one has trouble with the goods within 30 days, the dealer owes nothing and the obligation disappears. If there is trouble, the obligation is to comply with the warranty. The obligation, one might say, is contingent on the occurrence of a future event that brings the liability into being.

As the court held in *Huelbig*, unliquidated claims are those in which liability may have been admitted, but the amount of the debt is in dispute. When a driver admits responsibility for a car accident, but argues that the amount of damage to the plaintiff is considerably less than the plaintiff claims, the claim is no longer contingent, but it is unliquidated. When a court determines that a company has violated the antitrust laws but the court has not yet determined the scope of the damages, the damages are unliquidated. When a buyer purchases oil on a complicated pricing formula that includes future spot prices, until the price can be determined the amount owed is unliquidated. An obligation may be certain but the amount due may be unliquidated until the parties or the courts take further action.

There are multiple combinations. A claim may be contingent and unliquidated, as is the case with a breach of warranty before liability attaches or the amount of damage can be calculated. A claim may be contingent but liquidated, as is an indorsement on a note—the amount is known but liability has not been established.

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1. Note that the fraud debt, if proved, was dischargeable under section 1328, but is not after the 2005 Amendments, a point we discuss in the next section.— eds.
A claim may be noncontingent, but unliquidated, as in the example of the yet-undetermined amount of money due for an established antitrust violation.

The only debts that count toward the eligibility cap are those that are both noncontingent and liquidated. Of course, the liquidated or contingent status of a claim is seldom relevant in any context other than bankruptcy. Only in bankruptcy are claims accelerated for settlement. In a nonbankruptcy claim the plaintiff pursues the lawsuit until it is neither contingent nor unliquidated; then the plaintiff begins collection. In bankruptcy, however, the debtor's financial position and the discharge of debts depend not only on what is currently owed but also on what may be owed in the future, based on actions from the past.

The problem with the rule announced in *Huelbig* is that the rule on its face would permit a purely spurious claim by a creditor to block a debtor's access to Chapter 13. Other cases have suggested that the courts will consider the merits of the claim at the threshold in a limited class of cases where the claim is “farfetched.” See, e.g., In re Ho, 274 B.R. 867 (BAP 9th Cir. 2002) (cited and rejected in *Huelbig*).

The Chapter 13 restrictions on eligibility limit the kinds of debtors who will use Chapter 13. Those owing large amounts of debt (perhaps those running substantial businesses as sole proprietorships) will be denied access to Chapter 13 and must choose between Chapter 7 liquidation and reorganization through Chapter 11. Both options have, however, become more problematic. Chapter 7 access has been limited through the means test and other devices, while use of Chapter 11 by natural persons is now sharply limited as well.

Section 1129(a)(15) requires application of a Chapter 13 disposable income test in a Chapter 11 case involving a natural person. Like Chapter 13, everything the debtor earns after filing belongs to the estate, not the debtor, with the debtor receiving an allowance for living expenses. §§1115; 1306(a). But unlike Chapter 13, the Chapter 11 reorganization plan must provide for five years of disposable income regardless of whether the debtor's income is above or below median. Disposable income is defined with reference to the section 1325(b)(2) standard, so the pre-existing case law clearly applies to below-median Chapter 11 debtors, with the important difference of a five-year payout requirement. But section 1129(a)(15) does not mention section 1325(b)(3). Thus for above-median debtors it could be interpreted as applying the pre-existing disposable income caselaw under section 1325(b)(2) or the IRS budget means test under section 1325(b)(3), which some might argue is incorporated into section 1325(b)(2). As we have seen, which of those two tests is actually best for a given debtor in a given judicial district will depend on how the courts slice and dice the statutory requirements. As we will see in the business section, the Chapter 11 debtor must do more than meet the five year requirement. To confirm a plan, the debtor will need both the votes of creditors and the approval of the court, making Chapter 11 less attractive than Chapter 13, if other things are equal. Indeed, an individual debtor facing a hostile creditor holding a large percentage of the debt could find it difficult or impossible to use Chapter 11.

Nothing in the Bankruptcy Code explicitly requires that access to some form of bankruptcy be available to every person in financial trouble. Following the 2005 Amendments, it may be that some debtors will find themselves caught between chapters—unable to use Chapter 7, Chapter 13, or Chapter 11.
Problem Set 16

16.1. Harold Hunt is an oil well firefighter, a specialist in fighting runaway fires in oil wells. Harold is very good, but because he is afraid to fly he limits his work to the California area. He fights only three or four fires per year, but he earns about $40,000 per fire. Some years there are no fires, while other years there are seven or eight.

He is current on his bills, but he has come to you because of a judgment he has just suffered. Two years ago while on a visit to his mother's house he heard an argument between his mother and the plumber who was doing some work in the kitchen. The plumber called Harold's mother a number of very vile things. Harold says, "I lost my head." So did the plumber—at least a good portion of it. The plumber sued Harold and recovered a $360,000 judgment last week, despite Harold's plea of provocation. Harold has no money for an appeal bond and is afraid the plumber will attach his non-exempt house and other property. What do you advise him? See §§1328(a), 109(e).

16.2. Myrtle Tundra owes over $120,000 to banks, credit card issuers, and stores, and she has a $250,000 mortgage on her house. She has about $50,000 in non-exempt personal property. Her legal practice is doing well, and she makes about $100,000 a year. Myrtle has come to see you as a bankruptcy expert because she is nervous about a debt that she guaranteed for her former law firm.

The debt was the mortgage on the small office-building that the firm owned and in which it maintained its office. Her former partner, John Ice, kept the building as part of their agreed wind-up of the former firm's affairs. The mortgage is presently about $775,000, payable over 18 more years. The building is currently worth about $600,000, but it is in a rapidly developing area. A reliable real estate agent has told Myrtle that when a nearby freeway and shopping center are completed in about six months, the property will easily be worth $900,000.

John is having some trouble making the payments and may have missed this month's payment already. The mortgage is held by Loraine Ice, John's former wife, who hates both John and Myrtle for reasons Myrtle does not wish to discuss. Myrtle says Loraine would viciously exploit any default in an effort to hurt John and Myrtle. What is your advice? See §109(e).

16.3. Nino Riccini has been a successful computer design analyst for 16 years. Two years ago, Nino struck off on his own. He took advantage of the boom in Silicon Valley and the free-flowing capital to start a small firm, LectraFuture, Inc. After the investment absorbed $800,000, the first production run failed to sell out.

Nino has given up on the business and decided to go back to working for a larger company, but he finds that getting a good job is taking longer than he had expected. There is a temporary lull in the industry, and many older, higher paid design people have been laid off. Nino is sure he will find something soon. He doesn't want to appear panicked and reduce his bargaining leverage.

In the meantime, Nino's creditors are closing in. Nino has some cash in savings, but he needs help to prevent a foreclosure on his home, seizure of his car, and a host of minor but troublesome state law actions. What do you advise?

16.4. Julio Rodriguez is a technical wizard who left a high-paying job with Microsoft to found his own business. He developed a cell phone add-on that a couple of majors have marketed with varying degrees of success. When he first attracted their business, he expanded his production capacity quickly, then found that interest was
cooling. He now has almost $400,000 in unsecured debt owed to suppliers and investors as against inventory, machinery, and a couple patents worth altogether about $200,000. He is making about $65,000 a year from the business, but doesn’t think it has more than three years of viability unless he can come up with a new patent. He has lots of new ideas, but each one will take new money to develop. He has little personal debt, except a mortgage just over $500,000 on a small home in Palo Alto worth about $550,000. The housing bubble has begun to shrink a bit and he guesses he’d be lucky to pay off the mortgage if he sold, but for that reason he thinks the mortgage company would be glad to work with him. What are his alternatives under various chapters? As to Chapter 11, ignoring the other requirements for confirmation of a Chapter 11 plan, is section 1129(a)(15) a problem? Balancing it all out, what should you recommend to him? §§101(3), (4A); 707(b); 526-28; 1115(a); 1306(a); 1325(b); 1129(a)(15).

C. CHAPTER 12 FOR FAMILY FARMERS AND FISHERMEN

In the early 1980s a variety of economic developments struck hard at American farmers. Farmland bought on credit at high prices in the 1970s plummeted in value in many parts of the country, and crop prices were inadequate to permit farmers to service their mortgages. An increasing number of farmers turned to bankruptcy for relief, but those who wanted to keep their farms under a payment plan found themselves straddled uncomfortably between Chapter 11 and Chapter 13. Many family farmers were not eligible for Chapter 13 because they had too much debt in the form of mortgages on their farms and equipment. Yet the provisions of Chapter 11 are designed for businesses with more regular cash flow and involve a large degree of creditor control. Farmers felt they were being forced to conform to requirements that were inappropriate for them and were much more stringent than those imposed on salaried consumers making the same income.

The farmers’ discontent became law in the form of a new chapter in Title 11, Chapter 12. The new chapter was modeled on Chapter 13, so that it can be summarized by simply describing the principal differences between Chapter 13 and Chapter 12. The most important difference is in eligibility. A debtor can be eligible for Chapter 12 with far higher debts than for Chapter 13. Reflecting the economic realities of running even a modest farming operation, Chapter 12 has much higher debt limits than Chapter 13, totaling over $3 million. §§101(18)(A), 109(f).

Only "family farmers" are eligible for Chapter 12, a family farmer being defined by reference to percentages of income or debt related to farming. Yet Chapter 12 is more liberal than Chapter 13 in that a partnership or corporation can be a Chapter 12 debtor, in contrast to Chapter 13's strict limitation to natural persons, so long as the legal entity is owned by a single family and meets certain additional "family farmer" tests. §101(18), (21). The definition of family farmer is not the same as the definition of "farmer." §101(20). "Farmers" have some other special provisions scattered through the Code, such as the limitation on the ability of a farmer's creditors to force an involuntary bankruptcy. §303(a). As with a Chapter 13 debtor, the family farmer must have "regular income" to qualify for Chapter 12, but, again, in recognition of the special economics of farming, it may be regular annual income. §§101(19), 109(f).
Chapter 12 makes a major change in the standard for adequate protection in section 362 stay-lifting proceedings. The section 361 definition of adequate protection does not apply in Chapter 12. Instead, section 1205 sets forth modified standards for farmers. In particular, section 1205(b)(3) makes payment of a "reasonable" and "customary" rent sufficient for adequate protection regardless of any threatened decline in the value of mortgaged land.

Chapter 12 also changes the Chapter 13 plan requirements and constraints in important ways. It expressly permits the family farmer to modify a residential mortgage along with all other secured debt. It also permits the plan to last for more than five years to deal with secured debt. These two provisions in combination make it possible for the family farmer in Chapter 12 to address unsecured debts in the usual three- to five-year plan, while modifying (presumably decreasing) payments on secured debt by stretching them out over many years. §§1222(b)(2), (9); 1222(c). As with Chapter 13, the debtor must devote all "disposable income" to the plan during the three- to five-year period, but disposable income is determined after deducting business expenses. §1225(b)(1), (b)(2)(B).

One aspect of Chapter 12 makes it less attractive to debtors than Chapter 13. The Chapter 12 discharge is somewhat narrower than the Chapter 13 provisions. After a Chapter 12 case, an individual debtor remains liable on the same debts made nondischargeable in Chapter 7 by the provisions of section 523(a).

The 2005 Amendments extended Chapter 12 eligibility to family fishermen as well. The applicable provisions are similar, except that the total debt limit is $1.5 million, subject to inflation adjustment. §101(19A)-(19B).

D. THE CONSUMER BANKRUPTCY SYSTEM

1. Overview

At this point, anyone who has worked diligently through the materials should have a good grasp of the technical aspects of personal bankruptcy as well as its strategic uses. The reader should also have some sense of the policy issues that lurk in the structure of consumer bankruptcy. To complete the exploration of consumer bankruptcy, we offer here a reexamination of the system that assumes mastery of the details but that adds some new (and not merely legal) perspectives on the system.

The debtor-creditor relationship has been one of the most important social and political relationships throughout history in every society in which credit has been widely granted. Ancient Athens and the Roman Republic provide familiar examples of political and social upheaval associated with widespread burdens of debt. In America, bankruptcy is the dramatic focus of those tensions, even though the bankruptcy process is only part of a much larger system of consumer credit and consumer debt collection.

Consumer bankruptcy policy is today being debated around the world. The debates oscillate in the tension between the traditional idea of the fresh start and a pervasive fear of abuse. In a number of developed countries the growth of modern consumer credit
practices has occasioned a great increase in the number of wage earners and small proprietors who find themselves staggering under mountains of debt, leading to demands for a system that will relieve their distress and permit these citizens to begin their financial lives anew. At the same time, in every society there is a deep-seated concern that a relaxation of the traditional commitment to legal enforcement of promises to pay (traditionally, \textit{pact sunt servandum}) may represent a decadent trend that will undermine the commercial basis for a successful community. See generally, Jay Lawrence Westbrook, Local Legal Culture and the Fear of Abuse, 6 Am. Bankr. I. L. Rev. 463 (1998).

The discussion of each of these twin concerns has been divided between the two stages in the consumer credit process—before debts are incurred and afterwards. The debt-incurrence stage engages some who are concerned with debtors who will irresponsibly incur debts beyond their ability to pay, while others decry the irresponsible marketing of credit by financial companies. The post-incurrence stage, when the bankruptcy decisions are made, is the focus of some who fear that debtors will file for bankruptcy who could have paid their debts. Others are more concerned at that point that debtors who cannot pay will be left indefinitely in an unproductive and pointlessly cruel financial quagmire.

\textbf{a. Theories}

Until fairly recently there was little scholarly debate about the purposes of consumer bankruptcy or the overall approach of the United States system. See, e.g., Thomas Jackson, \textit{The Logic and Limits of Bankruptcy Law}, chapter 10 (inter alia, discharge leaves the risk of decisions about extending credit to creditors, who are best able to judge).

A few scholars have come forward in the last several years to suggest that a different approach should be taken. Some have argued that consumers should be freer to waive the protection of the bankruptcy laws and to contract with creditors for individual post-default regimes. See, e.g., Barry Adler, Ben Polak, and Alan Schwartz, Regulating Consumer Bankruptcy: A Theoretical Inquiry, 29 J. Leg. Stud. 585 (2000) (arguing that mandatory bankruptcy laws for consumers are inefficient). On the whole, however, there remains a broad consensus that supports some version of the present system, even as scholars have put forward a number of conflicting proposals for reform of that system.

Scholarly interest has focused primarily on the first aspect of the problem (\textit{ex ante} as professors like to say). One widely discussed theory of consumer bankruptcy treats it as analogous to insurance. The idea is that the cost of credit may be greater because creditors must account for the risk of the bankruptcy discharge at the time credit is extended, although it must be said that this increase is assumed rather than demonstrated. The insurance concept is that any increased cost of credit is the premium all borrowers pay for protection from the direst consequences of financial misfortune. The result is to spread the risk of financial misfortune across a large class of persons subject to the risk. As with any mandatory insurance scheme, however, the argument is made that it creates a “moral hazard” akin to the risk of carelessness about a possible fire arising from issuance of fire insurance.

Closely related is the assertion by many scholars that bankruptcy is a form of social safety net, supplementing unemployment insurance, public medical care, and the rest. It is argued that a country like the United States, which has chosen to have a much weaker set of protections for those who are less successful in economic competition, has more
need for consumer bankruptcy laws than other countries where universal medical care, subsidized housing, and generous unemployment benefits provide greater protection against the inevitable risks of a free-market economy. See, e.g., *The Fragile Middle Class*, 258-60.

It appears that the reason the scholarly discussion has focused on the pre-incurrance stage is that most of the empirical research shows conclusively that the debtors who file bankruptcy simply cannot pay. Once the debts are incurred, there is little to be done. Thus it has perhaps seemed more profitable to scholars to focus on the ex ante process. A major problem with that focus, however, is the lack of empirical data to support the theories, perhaps because of the difficulty of obtaining data about the ex ante effects of law. In any case, one result is that scholars have mostly ignored the political policy proposals because those proposals have been devoted largely to getting the debtors to pay after they file for bankruptcy. Professor Feibelman has collected and discussed much of the literature in his article, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 A.B.I. L. Rev. 1 (2005).

b. Policy Debates

The last few decades have seen an explosion in consumer bankruptcy filings, including a four-fold increase in the rate of filings from 1981 to 2000. Although business bankruptcies have also increased, there remains a strong sense that business cases are somehow different, that they do not implicate the moral and social issues found in personal bankruptcy. The great increase in consumer bankruptcies has driven a continuing policy debate about the role of personal bankruptcy in the consumer credit system and whether substantial reform is required. As with the theoretical literature, the debate involves two questions. Has this great increase been caused by some change in the economic system or is it the result of a change in the attitude of borrowers that causes people to load up on debts? Or are there more filings because debtors who are actually able to pay are flocking to bankruptcy? Again, the first question focuses on pre-bankruptcy conduct and economic conditions, while the second scrutinizes the debtors who seek bankruptcy relief.

While the questions may be phrased in a number of different ways and they may focus on the moment of taking on debt or much later on the time for declaring bankruptcy, the questions always seem to revolve around a central moral dispute: Do bankruptcy filings result primarily from irresponsibility or from misfortune?

Some argue that credit irresponsibility, whether it is the irresponsibility of the debtors who incur the bills or the irresponsibility of the lenders who extend credit, is the leading cause of bankruptcy, while others say that bankruptcies are more often the consequence of economic forces beyond an individual's control, such as layoffs on the income side or the cost of protracted illness on the debt side. The likely reason that the impact of these arguments has been largely rhetorical is that scrutinizing debtors' pre-bankruptcy conduct for irresponsibility, as opposed to fraud, is simply too laden with normative conundrums and practical difficulties. Finding fault in the complex mass of semi-predictable misfortune and debtors' quotidian decisions about incremental increases in debt is a far more difficult task than most researchers, legislators, or judges are prepared to take on. The credit industry's own behavior is laden with ambiguities, as creditors applaud the "democratization of credit" that has them lending to the poor and
the unemployed, while others characterize their actions as preying on the vulnerable and unsophisticated.

There is a case for the proposition that credit irresponsibility on someone's part is a major part of the problem. Consumer debt during the 1980s doubled from $300 to $600 billion. By 2004, it had more than tripled again, to more than $2 trillion, exclusive of almost $7 trillion in home mortgages. Federal Reserve Statistical Release Series G.19. The rise has been accompanied by credit-granting horror stories on the pages of the Wall Street Journal and elsewhere. We have read about the mass mailing of credit cards to all the inmates in a Louisiana prison. There was the Dallas man who came home from the foreclosure sale of his house to find a MasterCard Gold Card waiting for him. A dog got his Andy Warhol fifteen minutes of fame when the newspapers reported his receipt in the mail of a national credit card with a generous credit limit, only to be eclipsed by a credit card–holding cat a few weeks later. VISA now markets a credit card for the 13-17 year old crowd, suggesting that serious credit scoring does not lie behind the issuance of every credit card, and the new “Hello Kitty” credit card seems aimed for an even younger set. There seems to have been an extraordinary lowering of credit standards in the mass-marketing of credit. That fact has combined with often-mindless automation. (It turned out the prisoners got the credit cards because the computer saw that "they had stable addresses.")

The ads on page 221 are found around the country. One mailing that was sent directly to bankruptcy lawyers offered credit cards to their clients who had completed a bankruptcy. The client could sign up for the card with nothing more than a photocopy of his Chapter 7 discharge papers, and the attorney would receive a $10 finder’s fee. What a deal.
NO CREDIT
BAD CREDIT
SLOW CREDIT
BANKRUPTCY
SEE BOB LIPSEY MOTORS
IN BUSINESS 30 YEARS
NICE CARS TO CHOOSE FROM
♦ '92 TAURUS 4DR GL 47,000 MI
♦ '91 LUMINA EUROSPORT 47K MI
♦ '92 SATURN SL2 38K MI
♦ '91 SABLE STATIONWAGON LOADED
♦ '90 TOYOTA CAMRY EXTRA NICE
♦ '88 PARK AVENUE SUPER NICE
♦ '88 OLD 88, LOW MILES
♦ '87 HONDA ACCORD LX, AUTO
EASY QUALIFYING
BOB LIPSEY MOTORS
1508 W. ANDERSON LANE
451-0113

All
BAD CREDIT

OR
1ST TIME BUYERS – BAR NONE
Lowest Down
All Makes – All Models
BAR NONE
Lowest Payments
1-800-BAR-NONE
24 Hour Service
*10% minimum down  WAC
Aggressive marketing of credit has a close cousin—default rates of interest and penalty fees that make it nearly impossible for a debtor who has stumbled to catch up. In re McCarthy, 10493-SE (E.D. Va. 2004) (unpublished), illustrates what can happen to someone who falls behind. The opinion reveals that exactly two years before she landed in bankruptcy court Ms. McCarthy owed Providian $2021. During the intervening 24 months, she charged an additional $203, and she made payments totaling $2006, so her net payments to Providian were $1803. How much did she owe Providian? The company said that with interest and fees, she now owed $2608, which meant that she could make substantial payments month after month, with minor additional charges, and yet, as each month went by, she would end up owing more than the month before. Ms. McCarthy was in about the same shape with four other credit cards. For debtors who get caught in this debt nightmare, bankruptcy may be the only alternative.

Many pieces make up the consumer bankruptcy puzzle, but a very important factor is the explosion of consumer credit. Grasshopper consumers willing to live on the plastic edge of financial collapse have met a credit industry all too willing to oblige. The credit industry spends billions to make debt attractive, only to profess dismay over what results.

On the other hand, evidence also exists that increasing economic volatility in the modern American economy and the vulnerability of the American family as an economic unit put an ever larger share of the middle class at risk for economic collapse. Data reported in The Fragile Middle Class show that debtors report layoffs, serious medical problems, and the disastrous aftermath of divorce as principal reasons for their filings. A more recent study shows that about half of all families file bankruptcy in the aftermath of a serious illness or injury. Himmelstein, Thorne, Warren, and Woolhandler, Illness and Injury as Contributors to Bankruptcy, Health Affairs (February 2, 2005). By 2001, nine out of ten bankruptcies were tied in to job losses, medical problems, or family breakups, with many families reporting two or all three problems. Warren and Tyagi, The Two-Income Trap, p. 13.

Part of the explanation is that the economy that has generated so much wealth has rested upon a greater volatility of employment (especially downsizing and temporary workers) and much greater debt—personal, corporate, and governmental. Both unpredictable employment and spiraling debt are important factors in producing bankruptcy filings. Even in times of economic prosperity and low unemployment, families bear economic risk one household at a time, and the losers often find themselves in bankruptcy.

Critics of the present system have suggested one other cause for the great increase of filings, that bankruptcy has lost its stigma. Judge Edith H. Jones & Todd J. Zywicki, It’s Time for Means-Testing, 1999 BYU L. REV. 177. No empirical support has been offered for this hypothesis, while the interviews with debtors who explained how they were hiding their bankruptcies from families members, friends, neighbors, and co-workers seem to suggest otherwise. See Two-Income Trap, p. 13. Moreover, the fact that many of the debtors reported going without needed medical care (54 percent), not having prescriptions filled (43 percent), enduring utility shut offs (30 percent), and even going without food (22 percent) to try to pay their bills before they filed for bankruptcy suggests that bankruptcy was not the first-choice option that the critics claim. See “Illness and Injury as Contributors to Bankruptcy,” figure 4.

One factor that has clearly contributed to the increase of bankruptcy filings has been the explosion of consumer bankruptcy advertising following Bates v. State Bar of Arizona, 433 U.S. 350 (1977). Every Sunday TV guide in America (or at least every one we’ve checked) has multiple ads for consumer bankruptcy help. Some will regard this
fact as a perfect illustration of lawyer self-interest promoting unnecessary and counterproductive legal actions, while others will see it as contributing to a great awakening in average people to their legal rights.

In light of all these variables and uncertainties about the causes of the great increases in bankruptcy filings, the ex ante question has seemed too hard to answer. Thus the political debates have focused on the ex post question: Can these debtors pay?

As we saw earlier (see p. 13), the empirical data relevant to this question are not ambiguous. Most debtors are heavily indebted and most are unable to pay any substantial amount of their debts. Yet disagreements about appropriate legal constraints continue because of differing normative views about what conclusion to draw from the facts. For example, it has been suggested that it is an abuse for a family to file for Chapter 7 if they could pay a substantial part of their debts by living at the poverty level for five years. (This was the test employed by the credit industry-sponsored Credit Research Center in its first report to Congress.) Some will regard that conclusion as self-evidently correct, while others will think it an outrageous suggestion. The first group will say those debtors "can pay" and the second will say "you've got to be kidding." The data do have an impact, as discussed below, but naturally they have their effect in the context of normative beliefs.

There is another important but often ignored question that is highly relevant to the policy debate: "Do creditors suffer significantly greater losses in bankruptcy than outside it?" The answer to that question is not obvious, even if many commentators assume that it is. Credit card companies have conceded that about half of the debts listed in bankruptcy were already written off as noncollectible before the debtor filed. Of the remaining half, it isn’t clear how much would have been paid absent bankruptcy. Moreover, the debts that credit card companies list in bankruptcy often include penalty interest and late fees, along with credit actually extended.

If creditors are suffering greater losses in bankruptcy, then the question is whether bankruptcy could be reformed to require greater payment to creditors consistent with other normative values. If debtors could pay more under socially acceptable conditions, then reform would be appropriate. But if creditors are not being paid because debtors have so much debt relative to their incomes and assets that they could never repay—with or without bankruptcy—then it may be appropriate to look outside the bankruptcy system for a solution.

2. The Evolution of Consumer Bankruptcy Law

The fresh start was the dominant objective of the Bankruptcy Act of 1898. In 1938, the Chandler Act added Chapter XIII as a payout chapter for wage earners, but its stated purpose was not to coerce “can pay” debtors into mandatory repayment plans, but instead to provide legal breathing room for voluntary repayments by debtors who wanted to pay their debts.

The fresh start policy remained dominant in the Bankruptcy Reform Act of 1978, but with a much great push for consumer payouts. Personal bankruptcies had increased considerably in the preceding years, and Congress wanted to encourage debtors to try to pay. In addition to expanding the scope of Chapter 13 to include debtors who were operating businesses, Congress offered a set of incentives for filing Chapter 13, including an opportunity to save one’s home and a much broader discharge, which even covered
fraud and other intentional torts. Following the adoption of the 1978 Act, the percentage of bankruptcy cases that were filed in Chapter 13 rather than Chapter 7 jumped sharply, to about 30 percent overall. There remained, however, wide variations from district to district. Chapter 13 filings then stalled at that level for the next twenty-five years.

By 1984, the credit industry blamed the increase in bankruptcies on the provisions of the 1978 Act and pressed for more pro-creditor balance. The industry was successful to a limited, but important, extent. Under the 1984 Amendments, section 707(b) for the first time blocked access to Chapter 7 in cases of substantial abuse. Section 523 added a provision presuming fraud (and therefore nondischargeability) for certain debts incurred shortly before bankruptcy. The reaffirmation rules in Chapter 7 were rewritten so that it was easier for creditors to get enforceable promises to repay debts notwithstanding the bankruptcy, and in Chapter 13 the industry was able to add a requirement that all disposable income be devoted to paying creditors for at least three years. The importance of these provisions lay in the fact that they emphasized that debtors should pay more, even if they could not pay all they owed.

In 1994, the industry returned for more benefits, but the most important provision in that legislation established the National Bankruptcy Review Commission with nine commissioners and a law professor, Elizabeth Warren, in the role of Adviser. At each Commission meeting, consumer issues were hotly debated, often drawing substantial attendance and testimony that spanned several volumes. Its proposals were announced on October 7, 1997. The supporting discussions and dissenting views, are available online at http://govinfo.library.unt.edu/nbrc/index.html. The majority’s recommendations focused on such abuses as repeat filings by debtors and state exemptions that vary widely from stingy to excessive. The report did not embrace the changes that the credit industry thought important, and the Commission Report was denounced before it was delivered. Members of Congress sympathetic to the industry viewpoint turned away from the Commission recommendations, introducing bills with sweeping changes in the consumer bankruptcy system. The credit industry began a public relations campaign and well-financed lobbying effort. An eight year effort by the industry led to adoption of the 2005 Amendments.

From a policy perspective, the role of empirical studies in this process is especially interesting. It is fair to say that these studies had an important—but far from dispositive—role. See generally, Jay Lawrence Westbrook, Empirical Research in Consumer Bankruptcy, 80 Tex. L. Rev. 2123 (2002). In general, work done in the 1980s, including As We Forgive, showed that the overwhelming majority of debtors were unable to pay their debts. That work apparently convinced the industry that it required empirical refutation, so it funded a study from the Credit Research Center at Georgetown University that claimed that its data showed that many debtors could pay their debts. Although the actual study was never published nor were the data made available to government agencies that requested them, it provided a platform for legislation that introduced for the first time a means test for entering Chapter 7. On the other hand, the detailed study by law professors Marianne Culhane and Michaela White had a substantial influence in narrowing the means test to its present form. A study of women in bankruptcy by Teresa Sullivan and Elizabeth Warren led to the substantial preference shown domestic support obligations in the 2005 Amendments. On the broader issues, however, many in Congress made up their minds that a significant number of debtors were guilty of abuse and could pay; no amount of academic data to the contrary would prevent the legislation passing each house several times by gaudy majorities. Of course, the industry’s political generosity made its data more persuasive.
3. A Comparative Look

We often have a foolish tendency to assume that conditions and attitudes unique to ourselves govern our policy debates. That is even less true in a globalizing world than it used to be. It remains true, of course, that different cultures address similar problems in different ways, but there is often common ground that makes the differences illuminating for us.

Until the 1980s, the world of personal bankruptcy was easily, if roughly divisible into three main camps: the United States, the common law countries other than the United States, and the civil law countries. The common law countries generally permitted personal bankruptcy of both merchants and consumers and provided for a discharge. However, the discharge was much harder to get in those countries than in the United States, usually requiring years of payments under court supervision. Only in the last two decades have those countries begun to move in the direction of a faster discharge, led by Canada and the United Kingdom. The latter has now gone to a system that permits discharge within a year with minimal payments, a dramatic change from its law twenty years ago.

Traditionally, civil law countries have not permitted any form of personal bankruptcy for anyone other than merchants. In the last twenty years, however, a revolutionary change has occurred in Northern Europe and Japan, largely coinciding with the growth of deregulated, wide-open consumer credit à l’américaine. VISA and MasterCard have, no doubt unwittingly, taken the idea of a discharge with them as they have globalized their businesses. The consumer bankruptcy laws as first adopted in Europe and Japan were generally very restricted and as applied often granted few discharges. See, e.g., Rafi Efrat, Legal Culture and Bankruptcy: A Comparative Perspective, 20 Emory Bankr. Dev. J. 361, 390 (2004) (Israel). But governments in these countries have found over and over again that the debtors are unable to pay under the strict rules initially imposed. The legislatures have responded in many countries by relaxing the payment rules and lessening the time to discharge. See Jason Kilborn, La Responsabilisation de l’Economie: What the U.S. Can Learn From the New French Law on Consumer Overindebtedness, 26 Mich. J. Int’l L. ___ (forthcoming 2005). See also Junichi Matushita, Comprehensive Reform of Japanese Insolvency Law and Personal Insolvency, ___ Theoretical Inquiries in Law ___ (forthcoming 2005); Soogeun Oh, Law and Policy of Personal Bankruptcy in Korea – Challenges and Responses, ___ Theoretical Inquiries in Law ___ (forthcoming 2005). The consumer bankruptcy regimes in these countries remain stricter than in the United States, but with a definite trend in our direction.

On the other hand, an emerging theme in several countries is that “the debtors should pay something.” That is, even as lawmakers around the world come to realize that most debtors can pay little, there has been support for the idea that they should pay something because even symbolic payment and some time suspended in bankruptcy will deter abuse of the system and maintain commercial morality. So far, that proposition has not been put forward in the United States, but given the increasingly irrefutable evidence that our debtors cannot pay, it may prove to be tomorrow’s justification for tougher restrictions on discharge. Or the pragmatic American response might be, “We don’t make people suffer for symbolism if there ain’t no dollars.”

There is a strong connection between modern credit-granting methods and an increased need for personal bankruptcy laws. Indeed, an intriguing new study suggests a
powerful correlation between rising personal bankruptcy rates in a nation and the growth of credit card use in that nation, quite apart from the growth of consumer debt generally. Ronald Mann, Charging Ahead: The Growth and Regulation of Payment Card Markets Around the World (forthcoming). Thus we can expect to see a continued convergence of consumer bankruptcy laws around the world, although with the inevitable differences arising from different cultures and circumstances.

4. The Consumer Bankruptcy System Before and After the 2005 Amendments

Both anecdote and empirical evidence have demonstrated that the consumer bankruptcy system has always operated in ways not easily deduced from its statutory provisions, so we can be sure that it will take several years for the full range of effects of the 2005 Amendments to be established and several years more for practice manuals and empirical studies to report the changes. In this section, we look at the way in which the system worked prior to the amendments and consider how they may alter the process. Of one thing we can be sure, however: some changes that caught no one’s eye will turn out to be important.

With that humbling thought in mind, we can start with the fact that the 2005 Amendments did not make fundamental structural changes in the system. The discharge and fresh start remain the heart of the system and there are still two doors to the discharge: Chapter 7 and Chapter 13. Nonetheless, the amendments do represent a turning of a page in the long history of consumer bankruptcy in the United States and we can anticipate some important modifications in the way the system works. Note that we are not covering all the important changes, but only those that seem likely to have a systemic effect.

Abuses

The amendments are likely to constrict or to eliminate two practices that many considered abuses of the existing system. One was beyond doubt an abuse. Especially in California, many debtors repeatedly filed bankruptcy cases to use the automatic stay to block eviction by landlords even though the debtors had no intention of following through with the bankruptcy. Indeed, it was often true that the debtors did not know that bankruptcy would filed for them. They were just told, “There’s a legal way to hold up your eviction if you’ll just sign right here.” And, of course, pay a certain amount to the outfit offering the advice. The new provisions blocking use of the stay through serial filings of either Chapter 7 or Chapter 13 will reduce this abuse. §365(c)(3).

A number of debtors have filed so-called “Chapter 20” cases, in which the debtor files Chapter 7 and Chapter 13 in close succession. The Chapter 7 case discharges all debts dischargeable under section 523. The debtor can then put the nondischargeable debts (e.g., recent taxes) into a payment plan and pay them over time in Chapter 13. It was also sometimes used for debtors ineligible for Chapter 13 who nonetheless wanted to deal with home mortgages or car loans that were badly in default: The debtor would file for Chapter 7 and wipe out the credit card debt that put the debtor above the unsecured debt limits, then file for Chapter 13 and pay off the mortgage arrearage or car loan over time. Although the effect of a Chapter 20 was simply to prevent the dischargeable
creditors from riding the Chapter 13 coattails of the tax authorities, mortgage companies, or car lenders, many people saw it as an abuse. It is made impossible by section 1328(f), which denies a Chapter 13 discharge for a debtor who has gotten a Chapter 7 discharge within the prior four years.

Recoveries for Creditors

The central premise of the 2005 Amendments was that steering debtors into Chapter 13 would generate greater recoveries for creditors. But that is a factual assertion that is highly problematic. Even before the effects of the 2005 Amendments are known, it was hard to say that the pay-back in Chapter 13 greatly exceeds the repayment made by Chapter 7 debtors. Of course, most Chapter 7 cases are "no-asset" in terms of formal distribution, but, as Culhane and White found, more than 40 percent of the 1997 debtors formally reaffirmed one or more debts. In addition, Chapter 7 debtors make all sorts of other payments, including redemptions, payments against secured property that the debtors retain, and voluntary repayments.

On the other side, the promise of Chapter 13 is often unfulfilled. It now seems fairly well established nationwide that about 30 percent of the Chapter 13 cases filed actually result in completed payment of whatever was promised in the Chapter 13 plan. It is also clear that most plans propose substantially less than full payment, so that even completed plans do not mean full recoveries for creditors.

But Chapter 13 practice is marked by enormous variability. Data from the Office of the United States Trustee show that success rates in West Virginia and Oregon, for example, run at about 46 percent, while success rates in Florida are about 11 percent. Gordon Bermant and Ed Flynn, Measuring Projected Performance in Chapter 13: Comparisons Across the States, 19 ABI Journal 22, 34-35 (July/August 2000). Per-case yields to unsecured creditors varied from a mean of $4,603 in South Dakota to $443 in Connecticut. Unsecured creditors got only a small fraction of the disbursements to creditors. The Trustee study showed, for example, that Tennessee returned more money to unsecured creditors through its Chapter 13 program than any other state, in part because it leads the nation in the number of Chapter 13 filings, but the return to the unsecured creditors was only about 17.3 percent of all the creditor disbursements made through the program; secured creditors, who presumably would have collected either payments or property in Chapter 7 picked up the lion’s share of the Chapter 13 distributions. A single-district study in Mississippi in 1997 by Professor Scott Norberg showed even lower proportional repayments, with 89.5 percent of all payments going to secured creditors. Half of all the debtors he studied paid less than $146 total over the life of the plan to be divided among all of their unsecured creditors. Scott F. Norberg, Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13, 7 ABI L. Rev. 415 (1999).

In short, Chapter 7 and Chapter 13 do not represent no-payment versus payment. Instead, there is a spectrum of payment, most of it partial, and it is likely that the two chapters significantly overlap in the center of that spectrum.

It is hard to know if creditors’ recoveries will increase over the next several years. As noted earlier, unsecured creditors may actually do worse in bankruptcy after the 2005 Amendments because of the new Chapter 13 rules requiring many secured debts to be paid in full, regardless of the value of the collateral, leaving less for unsecured creditors. The best hope for unsecured creditors may be outside of bankruptcy. If increased costs
and other factors cause fewer debtors to file for bankruptcy, then unsecured creditors may be able to collect something more from those debtors. In that connection, if the United States Trustee approves as credit counselors primarily those nonprofit counselors supported by credit industry contributions, unsecured creditors may benefit from counselors who squeeze out additional payments through informal plans and who discourage the debtors from filing bankruptcy.

Another hope for unsecured creditors lies in a greater number of reaffirmations. New subsection 524(l) provides a bit of a safe harbor for the creditor. Perhaps more importantly, provisions such as the tightening of the presumption of fraud for eve-of-bankruptcy transactions in section 523(2)(C) and other such objections to discharge may provide the creditors with more occasions for plausible claims of objection to discharge, and those claims can be settled with reaffirmations.

All of these possibilities are speculative, however, so only time will tell if unsecured creditors will actually realize more recoveries after the 2005 Amendments.

**Domestic Support**

As noted above, recent empirical studies about the economic vulnerability that makes women more likely to file bankruptcy, along with pressure from women’s groups, resulted in stepped up protection for domestic support obligations found in our bankruptcy laws. Among other things, those obligations are given top priority in Chapter 7, and they must be current in order for a debtor to confirm or maintain a Chapter 13 plan. The improved priority position in Chapter 7 may amount to little because only a small fraction of consumer cases generate enough funds to pay any of the priority creditors. Moreover, the improvement in position moved alimony and child support creditors ahead of other classes of creditors (such as American fishermen collecting from fisheries) who had never given them much competition for the ex-spouse’s dollar. (In the process it created some serious complications in administering the statute. §507(a)(1)(C)). The Chapter 13 provisions may have more impact, but Chapter 13 already required that these debts be paid in full. Whether the impact of the change—demanding that past-due payments be made as a condition of confirming a plan—will be to get those owing domestic support obligations to pay up faster or simply to make them ineligible for Chapter 13 is not yet clear.

**Bankruptcy Rates**

There are several changes that might lower the number of bankruptcies filed. Some of them are discussed separately below. One that stands out is cost and delay. The amendments require vastly more paperwork, plus debt counseling before bankruptcy and post-filing financial counseling as a condition of discharge (see pp. 36-37.) All these steps will increase the cost of bankruptcy by some amount, depending, inter alia, on the policies adopted by the United States Trustee’s Executive Office as to the counseling requirements. The various requirements imposed on consumer bankruptcy lawyers require additional work and increase their exposure to liability for malpractice or for sanctions, likely increasing their fees. (See below.)

The increased delays may mean that some debtors will lose their property to creditors before filing. Having lost their immediate reason for seeking bankruptcy relief and being in most cases otherwise judgment proof, those debtors may decide not to file at
all. Because of the dilution of the automatic stay (e.g., section 362(b)(22)-(23), (c), (g)(2), (h)), other debtors may lose property shortly after a bankruptcy filing and accept dismissal for the same reasons, making it difficult for them to file again for a year. §362(c).

The drafters of the 2005 Amendments were clearly aware of the important role advertising has played in the increase in consumer bankruptcies. The amendments require various new disclosures by bankruptcy attorneys that may or may not make such advertising more expensive or less effective in advising debtors of the possibility of bankruptcy.

The credit industry’s position in the bankruptcy debates implied that the means test would also reduce bankruptcy rates by making bankruptcy less attractive to debtors who could after all pay their debts. Given that the data show that there have been very few such debtors in the past, we estimate that that change is unlikely to have much effect. But increased costs and attorney liability may do the trick.

**Chapter Choice**

Once a debtor considers filing for bankruptcy, the central question remains choice of chapter. Chapter 13 has always been voluntary. As we discussed earlier, until 1984 Congress attempted to influence debtors to choose Chapter 13 by offering carrots, such as a broader discharge and the ability to deal with secured creditors over time. In 1984 the adoption of the 707(b) substantial abuse standard introduced the first stick to prod debtors into Chapter 13. The length of the stick varied from circuit to circuit, depending on the extent to which ability-to-pay was considered a sufficient factor in a substantial abuse finding, but for the most part substantial abuse was found where debtors had ability to pay plus some wrongful conduct such as failure to disclose income or assets.

There may be a number of factors that influence filing rates in various localities, but we begin with the formal legal factors, starting with the fact that most debtors will retain a completely free choice, at least in theory. The means test will apply to only 10–15 percent of potential debtors, based on the profiles of those who now file. Among potential Chapter 7 debtors, the above-median debtors affected by the means test will likely be less than 5 percent of the total. (See pp. 52-55.) On the Chapter 13 side, almost 90 percent of those who now file in Chapter 13 are below-median debtors who could have filed in Chapter 7 despite the means test, so their choice will not be much affected either.

Chapter 7 will be available marginally less often than it is now, but eight years between discharges versus seven is not likely to influence many desperate debtors. Most of the onerous new paperwork and delay requirements apply to Chapter 13 debtors as well as those filing Chapter 7, so they are not likely to influence debtors’ choices to any great extent.

Thus it is the changes in Chapter 13 that are the place to look for probable changes in current patterns. Ironically (for a bill that was supposed to encourage repayment) the 2005 Amendments raised barriers to filing Chapter 13 as well. So, for example, a debtor who does not have enough cash to catch up on two years’ of child support payments cannot confirm a plan. A debtor who bought a car within the preceding two years or who has furniture or appliances bought on credit within the past year won’t have access to the stripdown, and that means the bare minimum of cash flow required to confirm a plan will be higher.
Resolution of certain open questions will determine the extent of further impediments to Chapter 13. A key question is whether the courts will permit zero payment or low-payment plans for debtors who are essentially restructuring secured debt only. In those districts that have always permitted such plans if the disposable income test was satisfied, we will see little change. Some districts that required some substantial level of payment as a matter of good faith, over and above the disposable income requirement, may look at the new structure and conclude that secured-debt restructurings are now encouraged by Congress. They may decide therefore that low-payment plans can be accepted following the amendments. In that case, there may be more Chapter 13s of that sort in those districts.

More generally, given that most potential Chapter 13 filers will be below-median debtors, the prior disposable income standard will may continue to apply in most districts, reducing the likelihood of change. On the other hand, in some districts that standard will be higher than the new means test and those courts may decide Congress could not have intended such a result. They may lower their disposable-income bar and thus encourage more Chapter 13 filings.

Several other changes will cut against the attractiveness of Chapter 13 filings. Debtors who are above-median in income, but are not barred from Chapter 7 by the means test will face the IRS budget for five long years in Chapter 13. They may decide that Chapter 7 looks much more attractive. The new rules requiring full payment of secured debts as a condition of retaining collateral even though the creditor is undersecured will leave many debtors with little money to pay unsecured creditors. As a result, in districts that continue to refuse to confirm zero payment or low payment plans, many debtors both below and above the median will be unable to propose a feasible Chapter 13 plan without surrendering the collateral. Most of those debtors will be below-median and eligible to file for Chapter 7, and many may choose to do so. By the same token, the fact that the Chapter 13 discharge has been narrowed to be almost the same as in Chapter 7 eliminates that incentive for filing for Chapter 13.

Finally, for all debtors, the cost of failure in Chapter 13 has risen substantially under the 2005 Amendments. Both anecdote and data suggest that most Chapter 13 cases fail. Under the pre-2005 system, it has been possible to refile fairly soon and try again. The new rules limit the automatic stay in such situations, sections 362(c)(3) and 109(g)(2), meaning, inter alia, that a failed plan may mean the loss of a home, while a Chapter 7 linked to a reaffirmation of the mortgage debt might save it. The below-median debtors who are eligible for Chapter 7—about 9 out of 10 of all debtors in the pre-2005 system—may therefore be safer in opting for liquidation rather than risk a failed payout. The same will be even more true for above-median debtors who qualify for Chapter 7 (because they are not caught by the means test) but who would face paying for five years in Chapter 13 while living on the IRS budget.

Lawyers

Study after study has confirmed that the key actor in each consumer bankruptcy is the debtor’s lawyer. See, e.g., Jean Braucher, Lawyers and Consumer Bankruptcy: One Code, Many Cultures, 67 Am. Bankr. L.J. 501 (1993). While the client has the ultimate right to decide, the complexity of the bankruptcy system, a complexity increased by the 2005 Amendments, means that the lawyer has an overwhelming influence over the decisions of most clients to file or not and which chapter to choose.
The drafters of the 2005 Amendments understood this particular point and set out to impose substantial responsibilities—and liabilities—on consumer bankruptcy lawyers. §§526-28. First, these lawyers are required to call themselves in any bankruptcy advertisement “debt relief agencies,” lumping them under that title with bankruptcy petition preparers who are not attorneys. This requirement presumably had two purposes. Along with a variety of required disclosures to the client, it ensures that lawyers must discontinue the shady practice in which some had engaged of advertising in ways that obscured the fact that bankruptcy was the help they were offering. (Thus they avoided the allegedly nonexistent stigma thereof.) The phrase also demeans all the lawyers who engage in the consumer bankruptcy practice, good and bad.

Every consumer bankruptcy lawyer has made a post-amendments list of all the reports that have to be prepared for a consumer bankruptcy and a list of all the sanctions that can be imposed for any mistake, including professional sanctions, court fines, and damage suits by the United States Trustee or the client. §§526-28, 707(b). These include provisions that may make the lawyer liable and sanctionable for failing to confirm the accuracy of the debtor’s valuation of assets, as well as to predict the interpretation of ambiguous terms, like the test for determining the replacement value of an asset. Some attorneys believe that the new rules also come perilously close to saying that the lawyer is liable if the court ever disagrees about a client’s eligibility for Chapter 7 and eventually tosses the case out. These sanctions and liabilities are concentrated in Chapter 7.

There are several possible effects of these provisions. One is that a certain number of lawyers, especially nonspecialists, will exit the practice. Those who remain will likely raise their fees, perhaps substantially. Those who are most concerned about liability, especially in the first years following the amendments when so many questions remain unanswered, may set up as owners of bankruptcy petition preparing companies, rather than lawyers. They might train others to give the advice. They might also be called in after filing to represent the debtor in an objection to discharge or lift stay motion, being separately paid for post-petition services. Or clever and experienced lawyers may come up with yet other devices for avoiding exposure.

There are some aspects of the present system likely to continue to attract lawyers to one chapter or the other for their clients. In the case that follows, a close-reading practitioner saw a benefit for his client in Chapter 13. The court, however, was not so enthusiastic about the innovation.

**In re SAN MIGUEL**

40 B.R. 481 (Bankr. D. Colo. 1984)

GUECK, Bankruptcy Judge.

The above matters were consolidated for hearing with respect to the good faith of proposed Chapter 13 Plans. Each of the plans proposes to pay unsecured creditors minimal payments of $1.00 each over a period of sixteen (16) months. The primary reason for selecting a Chapter 13 approach as opposed to Chapter 7 is to spread the attorney's fees over the sixteen month period. Otherwise, the individual circumstances of each case vary to one degree or another.

No creditor objected to the proposed plan in any of these cases. However, the Court, **sua sponte**, raised the issue of good faith due to the very short duration of each plan and the minimal payment afforded to unsecured creditors.
Each of the debtors is represented by the same counsel, Ed Cohen. Mr. Cohen argues forcefully and persuasively that the debtors are economically deprived persons who are entitled to a fresh start and whose good faith ought not to be questioned simply because they choose the avenue of Chapter 13 rather than Chapter 7. He argues that each of the proposed plans constitutes the best efforts of the debtors, that payments to creditors are capitalized over the sixteen month period to receive as much as they would receive in any Chapter 7 liquidation and that the plans were necessitated so that attorney's fees could be paid over the period of the plan rather than in advance as, he contends, is customarily required by lawyers who accept Chapter 7 debtors.

The Chapter 13 Trustee, while not objecting to any of the proffered plans, does point out that in a liquidation the creditors will receive their money upon liquidation. In the Chapter 13 adjustment, the payments are spread out over a period of many months, and the creditors always run the risk of default under the plans. Further, the Chapter 13 Trustee suggests that if debtors are to receive the advantages of Chapter 13, they should be expected to make a greater effort to comport with the Congressional intent of repayment to creditors, generally adhering to the Congressionally sanctioned period of 36 months as the normal duration of a plan.

Mr. Cohen counters that under the circumstances of the three cases presented herein, there is no real "advantage" to Chapter 13 as opposed to Chapter 7, except for the payment of attorney's fees over a period of time. He further states that, in his experience, no greater creditworthiness results from Chapter 13 than from Chapter 7.

A review of each of these three cases should be accomplished and examined in light of the history and purpose of Chapter 13.

RIVERA

Mr. and Mrs. Rivera owed approximately $10,000.00 in unsecured indebtedness. Mr. Rivera is an airman first class in the United States Air Force. His enlistment terminates in 18 months. He does not know if he will be eligible to reenlist, or whether he will desire to do so. He occupies an administrative position, and there is no indication that future raises, bonuses or promotions will be forthcoming in the foreseeable future.

The schedules submitted by the parties appear to be complete and accurate. There are no debts which are alleged to be nondischargeable in liquidation. The combined total net income of the parties is $1,002.00 per month. Their budget reflects expenses in the amount of $948.00. Mr. and Mrs. Rivera have proposed to pay the sum of $50.00 per month for a period of 16 months into the Plan so that attorney's fees in the amount of $690.00 can be defrayed over that period of time. Twenty-two unsecured creditors will receive $1.00 each. Mr. Rivera testified he feels this is their best effort.

LOPEZ

Mr. and Mrs. Lopez moved from Albuquerque, New Mexico to Denver in August, 1983. Mr. Lopez has been employed by Continental Airlines for 14 years. He was given 72 hours to move to Colorado or lose his job. Mrs. Lopez is employed by Sears, Roebuck & Co. as a customer service clerk.

Upon arriving in Colorado, the debtors purchased a home. Continental Airlines then declared bankruptcy and Mr. Lopez' salary was cut by one-half.
Several attempts were made to secure legal representation for the Chapter 7 liquidation. Mrs. Lopez testified that all lawyers whom they contacted wanted their fees in advance, together with the $60.00 filing fee. They contacted Mr. Cohen who suggested the Chapter 13 approach, with attorney's fees of $690.00 to be paid over the period of the plan. The schedules submitted on behalf of Mr. and Mrs. Lopez appear to be accurate and complete. There are no debts allegedly nondischargeable in a liquidation. The plan provides for $1.00 to each of the 8 unsecured creditors, extinguishing an indebtedness of $6,014.03. Payments of $50.00 per month are contemplated under this plan.

No changes in income are anticipated in the near future. Mrs. Lopez felt the proposed plan over 16 months was their best effort. The combined net monthly income of these debtors is $1,451.00. Their budget reflects expenses in the amount of $1,399.00. Mr. and Mrs. Lopez have three children. One daughter, age 16, desires to further her education beyond high school. The debtors wish to assist her, financially, in this regard. The daughter is reluctant to make plans for further schooling until it is determined that the parents will be free to assist her after the 16 month period.

The total secured indebtedness of these debtors consists of one secured creditor, secured by a first deed of trust on the family home, in the amount of $66,930.36. The value of the home is $71,610.00. This creditor will be paid outside the plan.

SAN MIGUEL

Mr. and Mrs. San Miguel have four children living with them, three of whom were Mr. San Miguel's children by a previous marriage. At the time of filing the Chapter 13 proceeding, Mr. San Miguel was in debt to the Department of Social Services in the approximate amount of $1,000.00 as a child support arrearage. He now has custody of the children. No support monies are owed directly to the mother. Nevertheless, Mr. San Miguel indicated he knew this debt may not be dischargeable. He intends to amend the Chapter 13 Plan to specifically provide for this indebtedness.

Mr. San Miguel is now on unemployment as a result of a back injury. However, this does not materially affect the scheduled income of the parties. Their combined net monthly income is approximately $1,689.00 with a budgeted expense of $1,610.00.

Mr. San Miguel indicated that, as experienced by the two previous debtors, his efforts to secure representation without the payment of advance fees for a Chapter 7 liquidation were futile. The Chapter 13 proceeding was chosen as a means to pay attorney's fees over the period of the plan. They propose to pay $75.00 per month into the plan for the 16 month period. This will discharge unsecured indebtedness of $4,021.60 to 6 unsecured creditors, including the aforementioned support obligation.

OPINION

No explanation was given by Mr. and Mrs. San Miguel for choosing not to exceed 16 months in their plan. No evidence is presented to indicate an inability to contribute funds beyond that period. In the case of Mr. Rivera, there is no evidence to indicate what type of employment or earnings he may achieve after his enlistment expires in 18 months. The only explanation given by Mr. and Mrs. Lopez for not exceeding 16 months was that they wished to help their daughter with her education.

In this District, we are guided in our determination of "good faith" by Flygare v. Boulden, 709 F.2d 1344 (10th Cir. 1983). While the Tenth Circuit set forth various
different criteria to be reviewed, the basic question to be determined is whether the plan constitutes an "abuse of the provisions, purpose or spirit of Chapter 13." If it does not, the plan should be confirmed. Flygare v. Boulden, supra.

The Tenth Circuit, however, did not intend that plans which pay to creditors at least what would be afforded by a Chapter 7 liquidation should be summarily rubber-stamped as being in "good faith." . . .

In the matters under consideration there are no malevolent motives in the selection of 16 month plans. However, there is no demonstrated desire for repayment of creditors in any of these plans either. There is the stated desire of achieving a fresh start in all three cases.

One of the Congressional purposes of Chapter 13, as expressed in Flygare, is the repayment of creditors. If a debtor simply desires relief from his or her debts, Chapter 7 provides an adequate remedy in most cases. The debtors would also achieve a fresh start sooner in a Chapter 7 liquidation, as attorney's fees are usually smaller and the financial affairs of the debtor are resolved much earlier.

In each of the cases now under consideration, the plan is careful to terminate immediately upon the final installment of attorney's fees. Only secured indebtedness and priority claims are paid to any real extent. There will remain at least as much excess in the budget after the expiration of 16 months as there is now.

The real purpose of the 16 month, minimum repayment plans here is to avail debtors of the opportunity to defer attorney's fees, since it appears difficult to obtain counsel in Chapter 7 without payment of fees in advance. While I understand the practical problems of securing counsel for Chapter 7 liquidations, I cannot modify the Congressional intent of Chapter 13, as expressed by the Tenth Circuit Court of Appeals, because of the local practice of attorneys regarding their fees. It does not appear to me that any of these plans promote the purpose of repayment of creditors. I am mindful that the failure to promote the purpose of legislation may not necessarily be tantamount to an abuse of the spirit and purpose of that legislation. Yet, where, as here, the true purpose of the proposed plan is simply to provide creditors, over a period of time, what they could achieve under Chapter 7 now, while paying the expenses of administration over a period of time, that seems to me to be an abuse (though not a "bad faith" subversion) of the spirit and purpose of Chapter 13, as promulgated by the Congress.

It is therefore ordered that confirmation of the three plans under consideration herein, as proposed, is denied. Each of the debtors is afforded an opportunity within fifteen (15) days to move to convert or to dismiss or to submit modified proposed Plans of arrangement for consideration by the Court and creditors.

The practice condemned in San Miguel is widespread, and some courts believe it is a legitimate use of Chapter 13. Even so, many attorneys do not press the issue, offering plans that are not so blatant about their intent. In conversation, attorneys routinely point to the debtor's need for time to pay the legal fees as a good reason to put a debtor into Chapter 13. A few creditors pick up some incidental repayment, and no one complains. This alternative has become even more attractive since the Supreme Court ruled that a debtor’s attorney cannot be paid under the literal language of section 330(a). Laime v. U.S. Trustee, 540 U.S. 526 (2004).
The twist (and there always seems to be a twist in bankruptcy) is that in a case in which the attorney puts the debtor in Chapter 13 so that the debtor can pay the attorney’s fees over time, the debtors may end up paying all of their disposable income to their creditors for three years, when a Chapter 7 would have been the right answer if they had only had the money for a legal fee. It seems to get things backward when the system puts debtors into Chapter 13 because they have so little money they cannot scrape together enough for the legal fees while their somewhat better-off counterparts can get immediate discharges in Chapter 7. There is a whole body of legend about how some consumer bankruptcy lawyers advise their clients to get the necessary fee for a Chapter 7 and thus avoid this problem, but no one has so far done the empirical study. It seems likely to us that this particular incentive to file in Chapter 13 will continue and, if fees rise, perhaps even be enhanced under the 2005 Amendments.

It may be that any substantial effect on Chapter 7 filing rates will be found here, in the pressure on the lawyers. Although we would like to think that lawyers’ concerns for clients would trump their own interests, the statute creates strong incentives for lawyers to put their clients into Chapter 13, both to avoid all the sanctions associated with a Chapter 7 filing and to get their fees paid under a Chapter 13 plan. The statute even goes so far as to forbid lawyers to suggest to debtors that they borrow money to pay the lawyer’s fee. §526(a)(4). Whether this includes borrowing from your mother or your brother, with full disclosure, is not clear, but these rules add to the incentive to use Chapter 13 to protect the lawyer’s fee.

Provisions so designed to put lawyer and client in confrontation are quite unusual in our law, so it is difficult to predict the results. There is a risk that the overall effect of the amendments is to increase the desirability of Chapter 7 for many debtors while making it harder and more expensive for them to find a lawyer who will file one.

Local Legal Culture

The current authors, along with their long-time co-author sociologist Dr. Teresa Sullivan, have raised the possibility that a major influence on consumer bankruptcy law as it is actually practiced is local legal culture. The Persistence of Local Legal Culture: Twenty Years of Evidence from the Bankruptcy Courts, 17 Harv. J.L. & Pub. Policy 801 (1994). The thesis was that each judicial district has a distinct legal culture sustained by bankruptcy judges, lawyers, and officials and that this culture determines many of the key variables in bankruptcy filings in that district. Thus, for example, the percentage of cases filing in Chapter 7 versus Chapter 13 varies greatly from one district to another even within a state. Moreover, the differences among districts in proportions of 7s and 13s have persisted over long periods of time despite major changes in the economy and in the governing law. The idea was that this culture went well beyond the inclinations of a given judge or a given time, because it persisted among the actors in the district over long periods. The thesis could not be proven, but was plausible in light of long-term trends in the bankruptcy courts not readily explicable by other factors, like variations in state laws. Since then, scholars from other countries have found similar phenomena. See Hans Peter Graver, Consumer Bankruptcy: A Right or a Privilege? The Role of the Courts in Establishing Moral Standards of Economic Conduct, 20 J. Consumer Pol’y 161 (1997) (Norway); Rafi Efrat, Legal Culture and Bankruptcy: A Comparative Perspective, 20 Emory Bankr. Dev. J. 361, 390 (2004) (Israel).

Chapters 4-6 have identified many examples of new and ambiguous concepts and terms in the 2005 Amendments. It takes considerable time for bankruptcy questions to
make their way to the higher courts, in part because having a specialized bankruptcy trial court adds an extra layer of review. The numerous ambiguities and anomalies combined with the powerful effects of local legal culture makes us confident that substantial variations in practices across the ninety-odd federal districts of the United States will continue for at least several years and perhaps long thereafter. The primary element in the system cutting the other way is the United States Trustee’s Executive Office, which has been given broad new powers to administer and monitor certain aspects of the system. An aggressive administration in that office could serve to some extent to bring greater uniformity, but it will be contending with powerful centrifugal forces.

Conclusion

It can be argued that the genius of the Western democracies has been in maintaining the lively edge of capitalism while preserving social stability and productivity through various devices that cushion the market's inevitable shocks to individuals and communities. Bankruptcy is an integral part of that machinery.

The changes made by the 2005 Amendments were important, but not fundamental. The bankruptcy system in the United States has always been the most pro-debtor in the world and it remains so. That system confounds a number of superficial economic analyses because it has helped to nurture a consumer credit market that is the largest, broadest, and deepest anywhere on the planet. The recent changes in detail are unlikely to alter that fact.

Based on past experience and the empirical data we have, the choices to file bankruptcy or not and which chapter in which to file will be much more controlled by the economics of the consumer credit system than by consumer bankruptcy law. We mentioned earlier the free granting of credit to those who have been recently discharged in Chapter 7. The growth of the market for "bad debtors" is sufficiently lively that credit counselors say they can no longer tell debtors in trouble that a reason to avoid bankruptcy is to protect their future access to credit. By the same token, no debtor need feel that the credit industry will treat a Chapter 7 filing worse than a Chapter 13, despite the years of sacrifice paying out a Chapter 13 plan. (Most credit bureaus apparently just enter "bankruptcy" in their files, regardless of the chapter and regardless of the amount paid in a Chapter 13.) The lessons taught by the market are likely to be much more powerful than those offered by the law.

Other influences may overwhelm any changes in the legal system. The great increase in “subprime” lending, which means lending to people who previously would have been denied credit, is reshaping credit in America. Harvard Business School researchers David Moss and Gibbs Johnson examined bankruptcy filings throughout the twentieth century. They document increased lending to families in the lowest income decile in the 1990s and argue that much of the rise in consumer bankruptcy filings can be attributed to lenders' aggressive push into much riskier—and more profitable—markets. David Moss and Gibbs Johnson, The Rise in Consumer Bankruptcy: Evolution, Revolution, or Both?, 73 American Bankruptcy Law Journal 311 (1999). To be sure, the credit industry has suffered much greater losses from uncollectible debts, but at the same time, it has enjoyed record profits. It seems that 29.9 percent interest and $50 late fees can offset a lot of bad debt losses and leave the companies making record profits. These sorts of developments are likely in the long run to have much greater impact than the details of a means test or the caselaw defining “abuse,” even though these developments are highly important to lawyers and their clients.
It is a much-debated question whether it is or is not a sound state of affairs to have many millions of people so highly indebted as in the United States. (A similar debate is ongoing about the high debt levels of our corporations and our governments.) But one cannot argue with the fact that our consumer bankruptcy laws have failed to inhibit the accumulation of more than a trillion dollars of consumer debt, most of which is paid when due. The changes made in 2005 will provide interesting and illuminating data about the effects of law, but as always much larger economic and financial trends will govern the system as a whole.

Having said that, the law does have a lot to do with the distribution of pain and gain in any financial system. The recent amendments are likely to pain consumers while reallocating wins and losses among creditors. They are also nearly certain to stimulate demands for further change. Bankruptcy, like any system for treating the ill and injured, can never do enough.

Problem Set 17

17.1. You are developing the consumer side of your bankruptcy practice, to go along with a flourishing small-business side. One morning while you are working on the management aspects of a bankruptcy practice, especially the expansion of the consumer side, Judge Carnes invites you to lunch. The Judge, as he is known around town, is one of the founding partners of your firm. He has been a highly respected member of the bar for 35 years.

The Judge spends some time asking how you like practice and complimenting you on developing an entire department at the firm when you are still so young. The Judge reflects on how the practice of law has changed through the years, and he asks about whom the firm serves in the bankruptcy practice. It seems that the Judge has heard from more than one source that the firm has had to turn away people in financial trouble because they couldn't pay in advance the $850 fee required for a Chapter 7. Yesterday he saw your memo suggesting that the fee will have to be raised substantially to cover the costs of the amended bankruptcy procedures. The Judge is convinced that some of these people are good people who happen to be in financial distress and asks if there isn't "something we can do to help out." What do you tell him? See §330.

17.2. After lunch you return to the office and begin to develop a checklist of the reports and certificates that the debtor and the lawyer must file in Chapter 7 cases and in Chapter 13 cases. You also list the sanctions available against a debtor and the lawyer in each chapter, making two columns for comparison. What’s on your lists? Given the need to control costs by controlling the amount of paralegal and lawyer time spent on each case, what rules of thumb will guide you in advising clients concerning choice of chapter?

17.3. As you continue to sketch out expansion of your consumer bankruptcy practice, you put together a memo for the management committee explaining the need to advertise. What reasons will you give? You also need to explain the requirements for consumer bankruptcy ads and to justify the costs. Assuming you will use newspapers and not radio or TV, you must lay out what will be in your proposed ad. What will your memo say in each regard? §§526-528. Should you anticipate another lunch with Judge Carnes?
17.4. Frank Forsythe is the beneficiary of a spendthrift trust that pays him $275,000 per year. Frank was a very strange child and he hasn't changed. Last year he was apprehended in City Park savagely beating Alice Harris. She was out jogging about 6:30 in the evening and he attacked her for no apparent reason. He struck her no fewer than 100 times with a claw hammer. She was in intensive care for three weeks. She has survived, but she is permanently disabled. Frank, who is currently out on bail awaiting trial, has debts to unsecured creditors of about $4,000 and about $10,000 of non-exempt personal property. He has been referred to you by his brother, an old friend of yours from college. The family is prepared to give you a $100,000 retainer. What will you do? See §§109(e); 1325(a)(3),(b); 1328(a).

17.5. You have gotten a call from Suzie MacIntire, who is the producer of Capital Issues, a program that runs on public TV stations all over the state. She is teeing up a show on bankruptcy. She's heard that you are a well-known practitioner and also active in State Bar policy development in the field. She wants you to start the show with a discussion of the basic purposes of bankruptcy law and an evaluation of the bankruptcy laws as they exist today in the United States. What notes will you make for your presentation?

17.6. Congresswoman Herring is back again. After the dust settles on the 2005 Amendments, she thinks there will be a lot of tweaking to be done to the statute and perhaps a backlash demanding additional changes. She wants your recommendation of one concrete consumer-bankruptcy reform that she could introduce and push through, believing that it would really improve things. Longer term, there is a good think tank in her district that needs more government work, and she would like to push a consumer bankruptcy study that would be really useful. For that purpose, she wants to know the best, most important factual question that could be answered by empirical research, as well as some idea of what kind of study would be necessary to answer it. She’s a practical woman, so suggest something that can actually be done.

Barney's Problem—Part II

Note: Unless otherwise indicated, the day this part of Barney's Problem is discussed in class is "deemed to be" March 1 of this year. This part of the problem, like the rest, is to be analyzed in "real time," i.e., as if you as counsel obtain the information or take the action indicated on the day (and the deemed date) the problem is to be discussed in class. All previous parts of the problem are incorporated into this part as of the day (and the deemed date) it is discussed in class, as if you were a sole practitioner in a town called Aloysius, and this small drama were real.

Your friend, Barney Thornaby, has consulted you this morning in a moment of panic about his rapidly declining financial affairs. As the discussion progresses, you manage to extract from him a partial idea of his deteriorating financial position.

On the personal side, he is still a licensed real estate broker and is worried about losing his license, because he knows he can always make a decent living selling real estate. He remembers from the exam he took that under state law the license of any broker who goes into "bankruptcy or any other liquidation proceeding" is revoked.
Barney's antique Packard was attached on January 2 in connection with a pending lawsuit seeking $250,000 in damages. In that lawsuit, a man named John Harris has charged Barney with fraud in the sale of a farm to Harris last year. Barney says that he is entirely innocent, but is concerned because "John Harris is the most accomplished liar I have ever known; he could sell shoes to snakes." Barney's deposition is set for next week, and he still hasn't consulted a lawyer about the case.

His main focus is on his construction company. In the past few years it has made about $300,000 per year after taxes, but it lost $250,000 during the past year. It is in trouble for two main reasons: (1) an enormous cash drain from its subsidiary, Barney's Auto Mow, Inc., and (2) weather delays on pending projects. While the business has some very profitable contracts and decent long-term prospects, the company is entirely out of cash.

The business is Barney's sole source of income, and he has personally guaranteed $50,000 of the company's loan from the Aloysius State Bank. The guarantee is secured by a lien on all his personal property. He has guaranteed an additional $75,000 of the business's debt to the bank, but this second guarantee is unsecured. ASB's president told Barney yesterday that she was very, very sorry, but she had reluctantly concluded that she would have to pull the plug on him. He assumes the bank will "foreclose" soon. He is behind on his personal bills, but aside from the mortgage they only total about $40,000. This amount includes about $4,500 he borrowed from his sister, Fortunata.

Barney bought his home on the edge of town in 1999 for $280,000. It is subject to a $250,000 purchase money mortgage held by the Farmer's State Bank.

Barney has a $1,000,000 whole life insurance policy that he purchased in 1999. He also owns a half-interest in a farm outside of town. The other half is owned by his brother, who lived on the place until he moved to Atlanta last fall. That farm is worth about $950,000, but is subject to a $800,000 mortgage. The Thornabys' other personal property includes two late-model cars, some antiques in the house, 100 shares of AT&T, and miscellaneous property such as silver, clothing, and jewelry. Barney estimates that it would cost about $100,000 to replace all this personal property. Your experience would suggest a liquidation value of about half the replacement value.

Barney shook his head and laughed grimly, thinking of how secure their life had seemed so recently. He gave his daughter a $10,000 diamond ring for her last birthday. He bought the ring from Cheryl Thornaby, his second cousin by marriage. The ring had been in the family for many years, but she needed money and had to sell it.

Although you have gotten Barney to see that he must consider bankruptcy because of his obligations to his wife and children, he keeps saying "Decent people don't go bankrupt. Decent people pay their debts. I'll never be able to hold up my head again. As a matter of fact, who would even deal with a realtor who is a deadbeat? God, I wish I'd shot myself."

Barney is tired, emotionally spent, and getting incoherent, so you tell him to go home and rest. However, he won't leave without your initial analysis and plan.

What else do you have to learn concerning each of the foregoing matters? What is your overall approach and advice?

Assume that Barney and his wife are both liable for all debts and that all their property is jointly owned. Also assume Barney's wife will follow your advice if you suggest she file for bankruptcy. Finally, unless you are told otherwise, assume the federal exemptions are available and are more desirable than the state exemptions.