

# CHAPTER 1: CONSUMER BANKRUPTCY

## INTRODUCTION

This year, more than a million American families will declare themselves bankrupt. They are bookkeepers, truck drivers, computer programmers, managers, department store clerks, loggers, executives, secretaries, accountants, plumbers' assistants, consultants, postal workers, machinists, day care workers, flight attendants, dentists, steelworkers, teachers, and waitresses. They work for large companies, for small companies, for the government, for themselves, and for no one. They are single mothers, single fathers, married couples, big families, and small families. What they have in common is that each one of them has filled out forms under penalty of perjury about their finances, walked into a courthouse, been sworn in for examination by a trustee, and waited for questions from their creditors. For nearly 1.3 million American families, the most important event of 1997 will be the public declaration that they are bankrupt.

Consumer bankruptcy has become part of America's economic landscape. Once regarded as an unlikely legal alternative chosen by only a few desperate families, bankruptcy had become a refuge for one in every 96 American families by the time the National Bankruptcy Review Commission filed its report. Journalists, academics, and lobbyists trained their sights on the bankruptcy system. Bankruptcy, a centuries-old phenomenon, has become a part of the changing world of consumer credit.

As bankruptcy filings increase, creditors justifiably worry whether a promise to repay has any meaning, while consumer advocates express concern that the financial distress of more than a million American families each year foreshadows a larger economic problem. The inherent conflict between the twin goals of bankruptcy – appropriate relief for those in trouble and equitable treatment for their creditors – ensures that it always will be an area of contention. To deal with financial loss, the bankruptcy system necessarily embraces competing interests. Recommendations fully endorsed by either debtors or by creditors would not maintain the balance essential to any consumer bankruptcy system. Bankruptcy is a system born of conflict and competing values. To function well, it must remain unpopular and controversial.

### **The Process**

The last 16 months have seen the single most concentrated national dialogue on consumer bankruptcy in history. The Commission devoted more time, more resources, and more energy to the development and debate of recommendations about consumer bankruptcy than it did to any other topic. A specific session devoted to consumer issues was part of almost every Commission meeting and hearing, so that consumer issues were explored in depth in Washington, D.C., Detroit, San Diego, Santa Fe, San Antonio, Seattle and Orange Beach, Alabama. More than 300 people participated in working group meetings or spoke in plenary sessions. In addition, the Commission received correspondence from an estimated 1,500 people on the subject of consumer bankruptcy. To broaden the scope of its discussions, the Commission developed a consumer bankruptcy mailing list with over 500 people who then received memos, proposals, and drafts as they were developed. In addition, the Commission website and other organization websites posted consumer materials.

The American Bankruptcy Institute added its energy and prestige to the debates, bringing together more than 50 experts representing diverse points of view for two meetings. Their efforts resulted in a number of new ideas the Commission pursued. Their final report included several near-unanimous recommendations, all of which were adopted by the Commission.

The Commission did not shy away from the consumer bankruptcy system's most controversial aspects. It explored the entire exemption structure, notwithstanding warnings that the subject was "too controversial" to produce any workable proposals. The reaffirmation of unsecured debt, repayment requirements for Chapter 13 debtors, and restrictions on access to the automatic stay were topics that produced sharp debate, but that ultimately resulted in Commission recommendations. Documented abuse by both debtors and creditors was thoroughly explored.

The Commission's discussions of consumer issues were open-ended, free-ranging, and passionate. In addition to the open forum scheduled for every

Commission meeting, three Consumer Bankruptcy Working Group meetings were completely open – prompting vigorous debates led by advocates both for creditors and for debtors – with a substantial number of trustees, judges, and academics adding their views. Anyone who could get to a meeting and who had something to say had repeated opportunities to be heard. Later in the process, when the Consumer Bankruptcy Working Group began to focus on particular issues, such as exemptions or the “substantial abuse” provision of section 707(b), large panels with a diverse group of representatives participated in the Commission discussions. In addition to their regular attendance and participation in every Commission meeting, representatives from the credit industry organized their own presentation to the Commission in December 1996, followed by a presentation in a similar format from debtors’ representatives in May 1997. Conflicting points of view were aired at every turn, repeatedly and forcefully.

### **The Proposals**

No area of bankruptcy law is more complex than consumer bankruptcy. Recommended changes often will have multiple – and sometimes unanticipated – effects throughout the system. The Commission reviewed more than 100 separate consumer proposals dealing with exemptions, dischargeability, audits and a wide range of other subjects. About a dozen proposals were considered in a comprehensive group and adopted in June 1997. Former Congressman and Commissioner Caldwell Butler then led the effort to develop more consensus, and on August 11, 1997, the Commission adopted a revised form of the proposals on his motion. At the same meeting, the Commission declined to adopt a competing set of proposals. Ultimately, the Commission adopted 34 individual recommendations. Commissioners continued to make proposals and to vote on them until the week before this report was completed for publication.

Most credit granting and most debt collection takes place outside the bankruptcy system. The Commission’s recommendations focus only on how the bankruptcy system operates as the “last stop” for troubled consumer debtors. The recommendations embrace three goals:

- Enhancing integrity and fairness in the system
- Reducing abuse by both debtors and creditors
- Increasing operational efficiency

Notwithstanding the vigorous debates, multiple proposals and votes, the Commission’s final report reflects remarkably consistent positions on a significant number of issues. The Commission almost without dissent supported the principle of uniform federal exemptions to end debtor abuse made possible by unlimited exemptions and to provide minimal exemptions for all debtors. While there were differences on the appropriate exemptions amounts, the fundamental concepts –

uniform rules on exempt property and restrictions on unlimited state exemptions – achieved broad support. Other concepts appeared in nearly all of the comprehensive proposals brought to the Commission for a vote, including those in the dissenting report, although sometimes they differed in detail. Among the recommendations with broad Commission support:

- Restrictions on serial filings
- Restrictions on reaffirmation of unsecured debt
- Random audits of bankruptcy schedules
- A statutory standard for valuation of property
- A national filing system
- Clearer rules for the treatment of secured debt following a Chapter 7
- In rem* orders to stop abusive filings
- Credit rehabilitation programs to increase Chapter 13 filings
- Increased plan completion with secured debt payments in Chapter 13
- Specified payments to unsecured creditors in Chapter 13 plans
- Automatic review and modification of Chapter 13 plans
- Uniform treatment of attorneys' fees
- Clarified rules governing the discharge of credit card debt
- Strengthened nondischargeability of family support obligations
- Amplified rules for objections to discharge
- Limitations on application of vicarious liability

Even when they differed on approach, the Commissioners agreed on the need for a more efficient consumer bankruptcy system. The extensive discussions of consumer bankruptcy disclosed individual differences about how the balance should be struck between debtors and creditors, which Congress itself undoubtedly will review, but the differences should not obscure the fact that a large number of concepts have been embraced by all or nearly all of the Commissioners.

The Commission identified some key areas in which neither debtors nor creditors can rely on the bankruptcy process to operate consistently, efficiently and fairly. The integrity of the bankruptcy system is crucial both to its ability to dispense justice for those who use it and to its support from the public generally. Serious questions were raised about the basic information that parties put into the system. These concerns prompted the Commission to recommend audits of debtors' schedules to ensure accurate disclosure of information. Attorneys representing all parties also have been criticized, prompting a continuing discussion of the responsibility of an attorney for the accuracy of the information filed. The Commission developed recommendations to deal with these specific problems that call into question the integrity of the system.

There is evidence of questionable use of the bankruptcy process by both debtors and creditors. Serious concerns about repeated bankruptcy filings led the

Commission to make recommendations that diminish the ability to use repeat filings for purposes other than financial reorganization. Some elaborate schemes have developed to prevent foreclosure or eviction through a combination of property transfers and bankruptcy refilings. The Commission recommends a statutory amendment to authorize the courts to use *in rem* orders to halt such abusive practices.

One of the proposed changes to federal exemptions would reduce other debtor abuses. The Commission recommends, for example, that state homestead laws be brought within a range, imposing both a floor and a ceiling on the value of homestead protection. By imposing a cap on exemptions, the Proposal would not allow individuals in states such as Florida, Texas, and Iowa to use bankruptcy to protect an unlimited amount of money in a homestead. Closing other loopholes in state laws that permit some individuals to shield unlimited assets from their creditors would have a similar effect. One of the most egregious examples of abuse would be eliminated.

Some creditors also have found ways to take advantage of the system. Abusive post-bankruptcy debt collection, documented in the courts and reported widely in the news media, led the Commission to recommend banning the reaffirmation of unsecured debt and providing more supervision for the reaffirmation of secured debt. The 1970 Commission recommended similar restrictions that might have avoided many of the current problems. Some creditors reportedly threaten to bring unfounded non-dischargeability actions that debtors cannot afford to defend as another way to collect dischargeable debt through reaffirmations. They would lose this option with the Commission's recommendation to set clear dischargeability rules for credit card debt.

The Commission addressed questions of integrity and fairness at another level as well. From the first hearing, the Commission heard from both debtors and creditors that some determinations that should apply consistently throughout the system have been left to individual judges and trustees. That can create a kind of luck-of-the-draw justice for debtors and creditors who learn that outcomes may sometime depend more on geography than on law. The Commission makes a number of recommendations, such as standardizing payments in Chapter 13 plans and determining the treatment of secured debt following a Chapter 7 case, that would settle disputes in the courts and ensure similar treatment for similarly-situated debtors and creditors everywhere.

Uniform exemptions, perhaps more than any other single proposal put forth by the Commission, would increase the fairness of the system by creating a baseline for exempt property applicable in all 50 states, so that debtors and their creditors would face more consistent rules regardless of where the bankruptcy was filed. A debtor would have the same opportunity to keep the car she needs to drive to work whether she lives in Missouri (\$1,000 exemption for cars) or Kansas (\$20,000 exemption for cars) when she files for bankruptcy.

The Commission also made a number of recommendations to increase the operational efficiency of the consumer bankruptcy system. The Commission recommends a clearer standard to value property, reducing litigation and uncertainty. A presumptive conversion to Chapter 7 upon the default of a Chapter 13 repayment plan will save the poorest debtors the cost of new filing fees and new attorneys' fees to receive a Chapter 7 discharge; this Recommendation also would save the system the administrative cost of multiple filings by moving debtors with inadequate representation and little hope of repaying their debts out of the system quickly. Automatic review of a Chapter 13 debtor's income for plan modification will save creditors the expense of continuous monitoring and missing increased repayments if the debtor's income rises significantly.

### **The Rise in Bankruptcy Filings**

The most visible and disturbing fact about consumer bankruptcy has been the extraordinary increase in filings in less than two decades. Since 1980, the rate of consumer bankruptcy filings has risen nearly three-fold. Recent trends are even more alarming. Bankruptcy filings jumped 11% during 1995 and another 27% during 1996. The increase in bankruptcy filings has occurred across the country -- in virtually every judicial district in America.

Who is "at fault" for the rise in consumer bankruptcies? The Commission struggled with this question but never reached a resolution. As Daniel Mica, president of the Credit Union National Association said at a meeting of credit union officials in September 1997: "When it comes to blame, there's enough to go around, both consumers and financial institutions."<sup>122</sup> Ultimately, however, the Commission can make no final pronouncement on why more families have financial problems that lead to more bankruptcy filings. It can only catalogue the surveys for Congress and note the enduring correlation between consumer debt and consumer bankruptcy.

In considering a variety of recommendations, however, the Commission tried to develop an appreciation for why bankruptcy filings have increased. If the higher number of consumer bankruptcy filings reflects an influx of debtors not in financial distress, then the system has lost its way by serving those who would take advantage of their creditors and, correspondingly, of everyone who pays their bills. But the statistical evidence suggests that consumers who file for bankruptcy today, as a group, are experiencing a financial crisis similar to the crisis faced by families when filing rates were only a fraction of their present levels.

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<sup>122</sup> Robert Macy, *Bankruptcies Concern Credit Unions*, AP ONLINE (Sept. 29, 1997) (quoting Daniel Mica, president of Credit Union National Association).

In 1981, two years after the 1978 Bankruptcy Code went into effect, Americans who filed for bankruptcy listed in their schedules short-term, nonmortgage debts that were, on average, slightly more than twice their annual income.<sup>123</sup> In practical terms, that meant the average bankrupt family would have had to set aside all of its income for more than two years just to pay the car loans, consumer finance loans, medical bills, credit card statements and other short-term debts, leaving nothing for food, clothing, housing, doctor's visits, utilities, insurance, or any other expense – including the money needed to make the interest payments on their short-term debts. For a family making \$26,000 a year, average short-term debts amounted to more than \$56,000, leaving an impossible choice between current expenses and interest payments on outstanding loans. If this family did not file for bankruptcy or reach some agreement with creditors, it simply would owe more the next day.

The statistics suggest that the picture has not changed appreciably since the early 1980s. Families filing for bankruptcy in 1997 apparently have incomes, assets, and debts little different from those of their counterparts nearly two decades earlier when bankruptcy filing rates were far less alarming.<sup>124</sup> The sharp rise in bankruptcies, these data suggest, cannot be attributed primarily to a group of “well-off” debtors who have decided that filing bankruptcy is somehow easier than paying the monthly bills. While some debtors in bankruptcy no doubt file for reasons that are illegitimate, most families come to the bankruptcy courts as they have for many years – seeking relief from debts they have virtually no hope of repaying.

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<sup>123</sup> TERESA SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 75 (1989).

<sup>124</sup> Hon. Barbara Sellers collected debt and income data on consumer debtors who filed for bankruptcy in 1997 in the Southern District of Ohio (unpublished data on file with Commission). The data she submitted to the Commission had a mean nonmortgage debt-income ratio of 1.9. (Data analysis by Matthew Ploeger on file with Commission; data weighted to represent proportion of Chapter 7 and Chapter 13 filers in district.) Professors Marianne Culhane and Michaela White submitted a preliminary copy of their research to the Commission. In their study of debtors who filed during 1996 in six states, they found a mean nonmortgage debt-income ratio among Chapter 7 debtors of 3.6, which they determined was not statistically different from the 1981 and 1991 Sullivan, Warren and Westbrook Chapter 7 data. Memorandum from Professor Marianne Culhane and Professor Michaela White to National Bankruptcy Review Commission (September 23, 1997). Nonmortgage debt-income ratios for both Chapter 7 and Chapter 13 debtors were statistically indistinguishable between 1981 and 1991. Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991*, 68 AM. BANKR. L.J. 121, 142 (1994). The four studies cited in this and the preceding footnote span four time periods (1981, 1991, 1996, 1997) and districts in eleven states (California, Colorado, Georgia, Illinois, Massachusetts, Nebraska, North Carolina, Ohio, Pennsylvania, Texas, and Wisconsin). They suggest that debtors in the 1990s are in as much or more financial trouble as debtors in the early 1980s.

Measured by bankruptcy filings, nearly four times as many American families are in serious financial trouble today as at the beginning of the last decade. Despite low unemployment, low inflation, low mortgage rates, and a long period of economic expansion, a growing number of American families no longer can make it from one paycheck to the next. This year, the Federal Reserve has reported that, once again, the growth in household debt exceeded the growth in disposable income.<sup>125</sup>

Why are so many Americans in financial trouble? The question haunts the economic prosperity of the 1990s. Answers for individual families depend on their own specific circumstances—layoffs, downsizing, moving from employee to independent contractor status, uninsured medical bills, car accidents, taking in a sister’s children, gambling, failed businesses, job transfers, caring for elderly parents, divorce, kids’ braces and school tuition. Answers for the country as a whole are far more difficult to determine.

The 1970 Commission noted the “tremendous rise” in consumer credit since World War II. In 1978, Congress initiated its discussion of consumer bankruptcy by observing that “[t]he result of the increase in consumer credit has been a corresponding increase in the number of consumers who have overburdened themselves with debt.”<sup>126</sup> Few would have expected that the debt levels and the bankruptcy filing rates of the 1970s would be viewed retrospectively as modest compared to the record levels achieved today.

Americans in the 1990s have unprecedented access to consumer credit, and the American economy has benefitted from that access. Consumer credit permits many Americans to buy what they need when they need it – cars, appliances, and clothing. It also enables them to make emergency purchases and to make long-term investments in homes and education. Greater access to credit has improved the quality of life for millions of American families. But the benefits of credit are not free. Between 1977 and 1997, consumer debt has grown nearly 700%.<sup>127</sup> For generations,

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<sup>125</sup> Monetary Policy Report to Congress, 83 FED. RESERVE BULL. 1, 19 (March 1, 1997).

<sup>126</sup> COLLIER ON BANKRUPTCY, Appendix Ch. 3, Leg. Hist. 1978 Bankruptcy Reform Act, App. Pt. 4-1201 (Matthew Bender 1996)

<sup>127</sup> The consumer debt calculation probably understates consumer debt because the correction needed to include home equity loans and auto leasing obligations can only be made as of June 30, 1992, the last date on which such figures are available from the Federal Reserve Board. The total consumer debt is calculated by adding \$517 billion (the 1992 home equity and auto leasing figures) to the Federal Reserve Tabulation of Consumer Credit Outstanding in 1997. If home equity loans or auto leasing have increased in the past five years, as have all other forms of consumer credit, the number used in the correction is too small. For a discussion of the understatement by an economist of the Federal Reserve Bank, see Francesca Eugeni, *Consumer Debt and Home Equity Borrowing*, FEDERAL RESERVE BANK OF CHICAGO: ECONOMIC PERSPECTIVES (March/April 1993).

Americans have experienced divorces, illnesses and uninsured medical costs, and job layoffs. However, never before have so many families faced these setbacks with so much consumer debt. The ordinary and not-so-ordinary troubles that families weathered a generation ago can become unmanageable for a family that already has committed several paychecks to meet monthly bills.

The common-sense observations of the Congress in 1978 about the increase in consumer debt have been borne out by more statistical analyses since then. Hon. Joe Lee, a distinguished bankruptcy judge in Lexington, Kentucky, and a 36-year veteran of the bench, offered his analysis to the Commission. Using Federal Reserve data, he calculated the amount of consumer credit outstanding every year since 1946 and the number of consumer bankruptcy filings each year. In the early 1970s, he reported, there were about 1.4 consumer bankruptcies for every million dollars of outstanding consumer credit. The proportion of bankruptcies dropped during the 1970s, but since then, consumer bankruptcies have been a fairly steady percentage of consumer credit. According to Judge Lee's calculations, in 1977 there were .74 bankruptcies for every million dollars in consumer credit; in 1997 there were .73 bankruptcies for every million dollars of consumer credit.<sup>128</sup>

Judge Lee's observation finds support in more complex studies. After a comprehensive analysis, the Congressional Budget Office told Congress that "nonbusiness bankruptcy filings move with measures of household indebtedness."<sup>129</sup> In another detailed statistical study, economists Jagdeep Bhandari and Lawrence Weiss reached a similar conclusion: "Our evidence indicates that the increase in the number of bankruptcy filings is primarily due to the increased level of debt as a percentage of income."<sup>130</sup> Economist Lawrence Ausubel, focusing particularly on credit card debt, noted that the rate of consumer bankruptcies is "astonishingly highly correlated with the rise in credit card defaults."<sup>131</sup> These studies offer a reminder that

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<sup>128</sup> Letter from Hon. Joe Lee, Eastern District of Kentucky, Updated Exhibits Regarding Consumer Credit, dated October 7, 1997, supplementing his letter and data to Commission Chairman Brady C. Williamson (October 25, 1996).

<sup>129</sup> Statement of Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office, before the Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, United States Senate, p. 4 (April 11, 1997) (documenting the historic correlation between consumer debt and bankruptcy filing rates).

<sup>130</sup> Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: A Historical Analysis*, National Conference of Bankruptcy Judges (Winter 1993).

<sup>131</sup> Lawrence Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L. J. 250 (1997) (documenting the correlation between consumer credit and bankruptcy filings generally and between credit card default rates and bankruptcy filing rates specifically).

talking about the rise in consumer bankruptcy filings without talking about the rise in consumer credit probably misses the point. Bankruptcy is largely a function of debt.

### **Why Bankruptcy?**

Although the correlation between debt and consumer bankruptcy is clear, in some sense it still begs the real question: why are so many families taking on so much debt and filing for bankruptcy? Bankruptcy and debt may be related, but that does not explain why some families fail and others do not. Many have offered their analysis of the factors that influence bankruptcy filings. A sampling:

*USA Today* focuses on the importance of state garnishment laws<sup>132</sup>

SMR Research identifies the significance of gambling<sup>133</sup>

Economist Ian Domowitz notes the importance of loss of medical insurance<sup>134</sup>

Attorney Lee Ringler cites the role of divorce<sup>135</sup>

Sociologist Teresa Sullivan identifies the influence of local legal cultures that steer debtors into or away from bankruptcy<sup>136</sup>

Undoubtedly, all of these commentators have identified important parts of the consumer bankruptcy picture that explain individual and regional variations. It is unlikely, however, that any one explanation will ever capture the variety of reasons that families fail.

The research presented to the Commission from the consumer credit industry concluded that “social factors,” rather than a rise in consumer debt, have caused the sharp increase in consumer bankruptcy filings. The study, funded by Visa, USA, said, “Such factors include changes in the bankruptcy laws, the reduced stigma associated with filing for personal bankruptcy and broader advertising of legal assistance with bankruptcy filings.”<sup>137</sup> A chief analyst at the Congressional Budget Office reviewed

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<sup>132</sup> Christina Dugas, *Special Report: Going Broke*, Tanya Albert, *Wage Garnishment laws a key factor*, USA TODAY, June 10, 1997, at 1A- 2A.

<sup>133</sup> SMR RESEARCH, *THE PERSONAL BANKRUPTCY CRISIS* 116 (1997).

<sup>134</sup> Ian Domowitz & Robert L. Sartain, *Determinants of the Consumer Bankruptcy Decision* 25 (1997) (unpublished manuscript presented to National Bankruptcy Review Commission).

<sup>135</sup> USA TODAY, *supra* note 132, at 3B.

<sup>136</sup> Teresa Sullivan, Elizabeth Warren, & Jay Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL’Y 801 (1994).

<sup>137</sup> VISA U.S.A. INC., *CONSUMER BANKRUPTCY: CAUSES AND IMPLICATIONS*, VISA CONSUMER BANKRUPTCY REPORTS 13 (July 1996).

the Visa study and other analyses submitted to the Commission. In an October 6, 1997, report to the Commission, he was critical of the model it used and characterized the research methods used in the study as “unscientific” and “invalid.” The report concludes: “Visa’s conclusion about the importance of social factors [on the bankruptcy filing rate] is unfounded.”<sup>138</sup>

A number of factors may influence the decision to file bankruptcy, and changing attitudes undoubtedly affect a family’s decision to seek legal help in the face of financial distress. As more families amass overwhelming debts, attitudes toward bankruptcy well may change. A debtor working two jobs to recover from a period of unemployment and facing a foreclosure may decide that bankruptcy is not as onerous as the alternatives. But the empirical studies seem to indicate that the sharp rises in consumer bankruptcy – 27% last year alone – may be more a function of a changing debt picture than of a sudden willingness to take advantage of the bankruptcy system.

### **Free Market Solutions**

Independent economists have been almost uniform in their conclusions that changes to the bankruptcy laws by themselves do little to change the overall picture of debt and credit industry losses. For example, Ian Domowitz and Elie Tamer of Northwestern University examined nearly 100 years of bankruptcy filings. They concluded that changes in the law to restrict access to consumer bankruptcy would have no substantial effect on filings.<sup>139</sup> In separate assessments of the data, Professors Domowitz and Eovaldi,<sup>140</sup> Professors Bhandari and Weiss,<sup>141</sup> and a government

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<sup>138</sup> Letter from Kim Kowalewski, Chief, Financial and General Macroeconomic Analysis Unit, Congressional Budget Office to Commission Chairman Brady C. Williamson (October 6, 1997).

<sup>139</sup> Ian Domowitz & Elie Tamer, *Two Hundred Years of Bankruptcy: A Tale of Legislation and Economic Fluctuations* 37 (May 1997) (unpublished manuscript submitted to the National Bankruptcy Review Commission).

<sup>140</sup> Ian Domowitz & Thomas Eovaldi, *The Impact of the Bankruptcy Reform Act of 1978 on Consumer Bankruptcy*, J. L. & ECON. (October 1993).

<sup>141</sup> Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increasing Bankruptcy Filing Rate: An Historical Analysis*, National Conference of Bankruptcy Judges (Winter 1993) (examining filing data, debt, and social variables). They conclude, “The introduction of the [1978] Bankruptcy Code does not appear to have had a significant effect on the rate of consumer bankruptcy filings. Our evidence indicates that the increase in the number of bankruptcy filings is primarily due to the increased level of debt as a percentage of income, and not to the change in the law.”

analyst<sup>142</sup> also conclude that changes in the bankruptcy laws have had little effect on consumer bankruptcy filing rates.

While economists generally agree that any statutory change is unlikely to have a significant effect on family decisions to file for bankruptcy, some have cautioned that tightening the bankruptcy laws could have an unanticipated effect: Two research economists have warned that new restrictions could encourage more lending to customers who are not creditworthy. That, in turn, could increase the number of defaults generally with the potential for more bankruptcies. Economist Mark Zandi has concluded that “Tougher bankruptcy laws will simply induce lenders to ease their standards further.”<sup>143</sup> Economist Lawrence Ausubel reached a similar conclusion.<sup>144</sup>

Changes in credit practices may have more powerful effects. The private market can have a significant influence on debt, default and, for some, bankruptcy. George Salem, a securities analyst with an investment research firm, testified to Congress that high default rates came about when credit card lenders “shot themselves in the foot by using some of the weakest and most pitiful loan underwriting techniques I have ever witnessed.”<sup>145</sup> Mr. Salem concludes that changes in underwriting standards, rather than changes in law, will address the problem more effectively. Other industry analysts agree that the better use of credit scoring would cut both delinquencies and bankruptcies. One industry consulting firm, August, Fair, Isaac & Co., released a new bankruptcy predictor that it says can eliminate 54% of bankruptcies by eliminating potential nonpayers from the bottom 10% of credit card holders.<sup>146</sup> The solution to the bankruptcy problem, say some market analysts, lies within the credit industry – not in federal regulation.

The experience of credit unions supports many of the remarks of the industry analysts. The Commission received hundreds of letters from credit unions, many explaining their careful screening before they lend to their members. Robert V.

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<sup>142</sup> Kowalewski, *supra* note 129, at 13-14; Mark M. Zandi, *Easy Credit, Profligate Borrowing, Tough Lessons*, REGIONAL FIN. REV. 16, 17 (January 1997).

<sup>143</sup> *Id.* at 17.

<sup>144</sup> “The predictable effect of further restricting the dischargeability of credit card debt is thus an increase, rather than a decrease, in the incidence of overextended consumers and an increase, rather than a decrease, in the already high rate of credit card delinquencies.” Ausubel, *supra* note 131, at 251.

<sup>145</sup> Statement of George M. Salem, Certified Financial Analyst, Gerard Klauer Mattison & Co., Hearing before the Committee on Banking and Financial Services, House of Representatives (Sept. 12, 1996).

<sup>146</sup> *Credit Cards: Fight for Bankruptcy Law Reform Masks Truth*, 162 AM. BANKER 30 (Sept. 8, 1997).

Burns, Manager of Multco Credit Union, joined creditors in a presentation to the Commission urging changes in the bankruptcy laws, but Mr. Burns gave some indication of how his institution already deals with bankruptcy:

We scrutinize loan applications, examine credit reports, verify income, and insure that a reasonable debt-to-income ratio is maintained. In short, we are responsible credit grantors providing reasonable credit limits in a reasonable way. The proof of that responsibility is demonstrated by the fact that our 1996 net charge offs for all reasons, including bankruptcy, will be less than \$75,000 [on a loan portfolio of \$34 million].<sup>147</sup>

The comparable charge-offs for typical credit card issuers on a loan portfolio of the same size would have been about \$1,224,000 (3.6%).<sup>148</sup> Mr. Burns said he forecast dramatic increases in his credit union's bankruptcy losses for 1997 and 1998, but those losses would have to increase 16 times over to match the industry average.

Other possible private market solutions, such as consumer financial counseling, are often underwritten by the credit industry as an alternative to deal with family finances that are out of control. Creditors help support such agencies financially as they provide both debt restructuring and credit education for their clients without the need for bankruptcy. Credit counseling cannot solve all problems, but it is an important part of the solution for debt problems and debt collection problems without involving the courts.

### **Alternative Approaches**

The Commission received a series of submissions from the credit industry advocating the general proposition that the bankruptcy system should be dramatically changed to require debtor-by-debtor scrutiny before permitting debtors to file for Chapter 7. The consumer bankruptcy debates never lacked a discussion of whether debtors are receiving "more relief than they need," although the cost and implementation of a "means testing" system were not developed in specific detail. These features are now detailed in the "means test" legislation recently proposed in H.R.2500. The Commission's discussion of consumer bankruptcy spanned more than

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<sup>147</sup> Statement of Robert V. Burns before the National Bankruptcy Review Commission (Dec. 17, 1996). Mr. Burns was not alone in citing these kinds of figures. For example, another credit union official wrote the Commission about a 1023% increase in bankruptcy losses in 1996. He identified 1996 bankruptcy losses of \$22,162 on an asset base of \$23 million, a loss ratio of less than 0.001%. Letter from Joe Irish, Collections Officer for Fergus County Federal Credit Union, to National Bankruptcy Review Commission (July 16, 1997).

<sup>148</sup> Data from Visa U.S.A., Inc., *Consumer Bankruptcy: Causes and Implications*, figure 1, p. 5 (July 1996) (reporting industry losses of 3.6% industry-wide for bankruptcy and nonbankruptcy losses.)

a year and involved more than 100 votes. One Commissioner incorporated the means testing concept in a comprehensive proposal submitted to the full Commission, but withdrew this portion from the proposal just before the Commission voted on it. It now appears in the individual Commissioner's views in Chapter 5.

A study funded by the credit industry supports the contention that substantial numbers of debtors who file for bankruptcy could repay some of their debts. The Purdue Study, conducted by Dr. Michael Staten, was presented repeatedly to the Commission in support of the credit industry's call for a means test for consumer bankruptcy. The study has been criticized by researchers,<sup>149</sup> and the General Accounting Office is completing an audit of the data presented. A chief analyst of the Congressional Budget Office reviewed the Staten study, questioning the reliability of the its findings and characterizing the study as "misleading." He concluded that the defects in the study may "contribute to an overstatement of [the debtors'] capacity to repay."<sup>150</sup>

Some witnesses concluded that using a means test to establish Chapter 7 eligibility would fall hardest on families already financially pressed past the breaking point, with little provable benefit. Others expressed their concern that, with a completion rate of only 32% for *voluntary* Chapter 13 plans today, forcing unwilling debtors into Chapter 13 would only burden the system, decreasing both the overall repayment to creditors and the successful rehabilitation of debtors. The 1970 Commission reached the same judgment: "The Commission has concluded that forced participation by a debtor in a plan requiring contributions out of future income has so little prospect for success that it should not be adopted as a feature of the bankruptcy system."<sup>151</sup> In a time of increasing strain on judicial resources, questions also have arisen about the number of judges, clerks, and other staff needed to administer a means test to hundreds of thousands of debtors annually. The credit industry has sought means testing consistently for at least 30 years,<sup>152</sup> but Congress has

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<sup>149</sup> Letter from Ian Domowitz, Professor, Department of Economics and Institute for Policy Research, Northwestern University, to Brady Williamson, Chairman, National Bankruptcy Review Commission (June 9, 1997); Letter from Marianne Culhane and Michaela White, Professors, Creighton University School of Law, to Brady Williamson, Chairman, National Bankruptcy Review Commission (June 11, 1997); Statement of Professor William Whitford before the National Bankruptcy Review Commission (January 23, 1997).

<sup>150</sup> Kowalewski, *supra* note 138, at 9.

<sup>151</sup> REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, Part I at 159 (1973).

<sup>152</sup> *Oversight Hearing on Personal Bankruptcy, Committee on the Judiciary Subcommittee on Monopolies and Commercial Law*, 97th Cong. 2 (March 25, 1982)(statement of Professor Frank R. Kennedy, Former Executive Director, Commission on the Bankruptcy Laws of the United States, discussing "compulsory Chapter XIII proposals proposed by the credit industry between 1960 and

consistently refused to change the basic structure of the consumer bankruptcy laws.

There is no dispute on one point: bankruptcy should be used only by the needy and not by others. The bankruptcy laws should *never* invite abuse. When Congress charged the Commission with its duties, it cautioned that there was no evidence that the bankruptcy system needed radical reform. It characterized the system as “generally satisfactory,” and directed the Commission to review, improve and update the Code “in ways which do not disturb the fundamental tenets and balance of current law.” The Commission conducted an intensive review of consumer bankruptcy that resulted in a full set of recommendations, but the proposals contemplate no change in the basic structure of consumer bankruptcy. Access to Chapter 7 and to Chapter 13, the central feature of the consumer bankruptcy system for nearly 60 years, should be preserved.

### The Next Twenty Years

Some creditors are looking for new ways to find customers, as some consumers look for new ways to obtain and use credit. The Commission has learned about several new products and practices that Congress may want to take into account as it fashions changes in the bankruptcy laws and other laws for the next 20 years:

**Good Borrowers are Bad Borrowers.** Credit card issuers earn about 75% of their revenues from the interest paid by borrowers who do not pay in full each month.<sup>153</sup> Several companies have instituted charges or even canceled credit cards for customers who pay in full each month.<sup>154</sup> Companies have offered cash incentives to encourage customers with large balances elsewhere to transfer to their cards..

**Gambling on Credit.** The availability of cash advances on both credit cards and home equity lines of credit enhances the ability to gamble using ordinary consumer credit. Placement of automatic teller machines to dispense cash in and near casinos has made it easier to borrow for gambling. New research suggests that the spread of gambling may be accompanied by an increase in

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1970”).

<sup>153</sup> DAVID S. EVANS & RICHARD L. SCHMALENSEE, THE ECONOMICS OF THE PAYMENT CARD INDUSTRY Fig. 3 (1993).

<sup>154</sup> One bank recently canceled MasterCard for 12,000 customers who pay their bills each month in full; they are expected to cancel another 30,000 customers soon. Other lenders have imposed fees on customers who do not carry debt from month to month. Bruce Mohl, *The Careful Debtor Loses Credit at BJ's*, BOSTON GLOBE, Sept. 25, 1997, at A1.

families' financial failure: SMR Research Corporation has found that bankruptcy rates are significantly higher than the national average in counties with gambling facilities. The newly established Gambling Impact Study Commission began its hearings with testimony linking gambling and consumer bankruptcy, and the U.S. Treasury Department has recently received an appropriation to study the relationship between gambling and bankruptcy.

**Vigorous Marketing.** Consumer credit is a profitable banking activity; even with high losses, credit cards are about twice as profitable on average as all other banking activities.<sup>155</sup> Mark Zandi, Chief Economist for Regional Financial Associates, notes that lenders have mailed 2.5 billion credit card solicitations each year for the past three years.<sup>156</sup> This amounts to 75 mail solicitations for each household -- without considering telephone marketing, print advertisements, and other forms of marketing. While rising losses have caused some creditors to reduce their solicitation of new business, some creditors apparently see default rates dropping, so that "banks and financial service companies are preparing to once again step-up mass marketing of credit cards."<sup>157</sup>

**Sub-prime Lending.** Companies specializing in lending to borrowers with tarnished credit histories have been among the fastest-growing credit issuers in the past five years.<sup>158</sup> Although losses are substantial, effective interest rates of 18 to 40%,<sup>159</sup> make this profitable. General credit issuers have recently entered the sub-prime credit market, which suggests that such marketing may expand.<sup>160</sup> Some industry analysts predict that sub-prime lending will cause total loan default rates to double by the year 2001, warning

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<sup>155</sup> Lawrence B. Lindsey, Member, Board of Governors of the Federal Reserve System, Testimony before the Committee on Banking and Financial Services, U.S. House of Representatives, Sept. 12, 1996.

<sup>156</sup> Zandi, *supra* note 142, at 16, 17.

<sup>157</sup> Brad Hoeschen, *Banks Ready to Renew Credit-Card Recruiting*, BUS. LAW. J. 1 (August 1, 1997) (quoting spokespersons from leading credit card banks).

<sup>158</sup> Dow Jones & Company, Inc., Capital Markets Report (Oct. 7, 1997) (noting an increase from \$80 billion in sub-prime loans in 1992 to \$150 billion in 1996).

<sup>159</sup> Robyn Meredith, *Will Ford Become the New Repo Man?*, N.Y. TIMES, Dec. 15, 1996, at A1.

<sup>160</sup> Ford Credit, for example, recently announced an "ambitious plan" to enter the sub-prime lending market. *Id.* Other mainstream lenders, including FDIC-insured banks, have entered this market as well. Barbara Rehm, *In a First, FDIC Warns Banks About Dangers of Subprime Lending*, 162 AM. BANKER 2 (May 13, 1997).

that “by lowering their credit standards and saturating the market with loans, many banks will be unable to avoid potentially enormous delinquencies and write-offs.”<sup>161</sup> On May 2, 1997, the FDIC issued a warning about the risks posed by increased sub-prime lending.<sup>162</sup>

**Soliciting Young People.** Another high growth customer group is teenagers. Cards are available at many colleges to almost any student -- no income, no credit history and no parental signature required.<sup>163</sup> The Commission received an advertisement for a two-day workshop for creditors entitled “Competing in the Sub Prime Credit Card Market,” including a presentation entitled “Targeting College Students: Real Life 101” with tips on how to “target the money makers of tomorrow.”

**Targeting Lower-Income Americans.** The largest growth in consumer credit in recent years has been among the poorest Americans. The Federal Reserve’s Survey of Consumer Finance notes that while debt burdens generally are falling for families with incomes over \$50,000, families with incomes below \$10,000 are increasing their debt.<sup>164</sup> Some banking industry analysts explain rising credit card default rates by noting that “the issuers, in our opinion, have chosen to extend credit to individuals in a lower stratum of the creditworthiness spectrum compared with prior cycles. . . . These persons don’t handle credit well, and/or qualify for little credit based on capacity to repay.”<sup>165</sup> The Consumer Federation of America identifies a phenomenon known as “bottom-feeding” in which “card issuers increasingly . . . targeted less affluent groups.”<sup>166</sup>

**Home Equity Lending.** Home equity lines of credit, virtually unknown a decade ago, have permitted many American families to make significant

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<sup>161</sup> Tom Neagle, manager, Financial Institutions Group of A.T. Kearney, Chicago-based management consulting firm, quoted in *Give me your delinquents, your former bankrupts, yearning to borrow* . . . , 88 ABA BANKING J. 31, 63 (August 1996) (discussing consulting firm study).

<sup>162</sup> Rehm, *supra* note 160.

<sup>163</sup> A Commission volunteer picked these up at campus bookstores. Samples are in the Commission files.

<sup>164</sup> Family Finance in the U.S.: Recent Evidence from the Survey of Consumer Finance, 83 FED. RESERVE BULL. 1, 21 (1997)

<sup>165</sup> George M Salem & Aaron C. Clark, CFA, *Bank Credit Cards: Loan Loss Risks Are Growing*, Banking Industry Report GKM, 7 (June 11, 1996).

<sup>166</sup> Stephen Brobeck, Executive Director, Consumer Federation of America, *The Consumer Impacts of Expanding Credit Card Debt*, 9 (February 1997).

purchases – financing an education, renovating a home, or consolidating debt obligations at lower interest rates. Regulations governing the solicitation of home equity lines of credit will permit more aggressive marketing beginning on October 1, 1997. Prior to the change, lenders who wanted to take a mortgage on a home could advertise only for customers to apply; now lenders can send pre-approved lines of credit for home equity loans.<sup>167</sup> Lenders offer credit cards, equity checks, and overdraft protection to homeowners. In addition, some new home equity lines of credit exceed the value of the home. While some lenders will not lend on a partially secured basis, other lenders now routinely issue lines of credit at a loan-to-value ratio of 125 percent, thereby increasing the amount of credit available. While home equity borrowing is sometimes less expensive than credit card debt, it means that homeowners risk losing their houses if they are unable to make timely repayments.

**Post-Bankruptcy Credit.** Bankruptcy used to end access to credit for a consumer for at least a decade. Laws restricted to 10 years the length of time that credit reporting agencies could list consumer bankruptcies so that debtors eventually would have some chance to renew their credit. A study by Dr. Michael Staten, then-Director of the Credit Research Center of the Krannert School of Business of Purdue University, documents the practice of soliciting debtors for new credit shortly after their bankruptcy discharges.<sup>168</sup> Dr. Staten notes that these debtors are attractive to some credit issuers because they have shown they will take on credit and, by law, they cannot seek a bankruptcy discharge for another six years. He suggests that such credit practices have reduced the disincentive for debtors to file for bankruptcy.

The Commission's recommendations are developed in detail in the following pages. The views of the Commissioners who dissented from the proposals and their analysis are developed at length as well in Chapter 5. Their views are strongly held. So are the views of the five Commissioners who supported all of the Commission's consumer bankruptcy recommendations.

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<sup>167</sup> 15 U.S.C. §1681a(1) (1995).

<sup>168</sup> Michael Staten, Director, Credit Research Center, Krannert School of Management, Purdue University, *Working Paper No. 58 The Impact of Post-Bankruptcy Credit on the Number of Personal Bankruptcies* (January 1993).

The discussion of each recommendation includes more detail about consumer credit, bankruptcy data, case law, and statutory amendments over the past 20 years. The recommendations represent the Commission's best efforts – in some instances by a 5-4 vote and in others by more substantial margins – to highlight problems and to develop creative, effective solutions that will maintain the balance in the consumer bankruptcy system for another 20 years and beyond.

## RECOMMENDATIONS

### 1.1.1 *National Filing System*

A national filing system should be established and maintained that would identify bankruptcy filings using social security numbers or other unique identifying numbers.

### 1.1.2 *Heightened Requirements for Accurate Information*

The Bankruptcy Code should direct trustees to perform random audits of debtors' schedules to verify the accuracy of the information listed. Cases would be selected for audit according to guidelines developed by the Executive Office for United States Trustees.

### 1.1.3 *False Claims*

Courts should be authorized to order creditors who file and fail to correct materially false claims in bankruptcy to pay costs and the debtors' attorneys' fees involved in correcting the claim. If a creditor knowingly filed a false claim, the court could impose appropriate additional sanctions.

### 1.1.4 *Rule 9011*

The Commission endorses the amended Rule 9011 of the Federal Rules of Bankruptcy Procedure, to become effective on December 1, 1997, which will make an attorney's presentation to the court of any petition, pleading, written motion, or other paper a certification that the attorney made a reasonable inquiry into the accuracy of that information, and thus will help ensure that attorneys take responsibility for the information that they and their clients provide.

### 1.1.5 *Financial Education*

All debtors in both Chapter 7 and in Chapter 13 should have the opportunity to participate in a financial education program.

**1.2.1** *Elimination of Opt Out*

A consumer debtor who has filed a petition for relief under the Bankruptcy Code should be allowed to exempt property as provided in section 522 of the Code. Subsection (b)(1) and (2) of section 522 should be repealed.

**1.2.2** *Homestead Property*

The debtor should be able to exempt the debtor's aggregate interest as a fee owner, a joint tenant, or a tenant by the entirety, in real property or personal property that the debtor or a dependent of the debtor uses as a residence in the amount determined by the laws of the state in which the debtor resides, but not less than \$20,000 and not more than \$100,000. Subsection (m) of section 522 should be revised to reflect that all exemptions except for the homestead exemption shall apply separately to each debtor in a joint case.

**1.2.3** *Nonhomestead Lump Sum Exemption*

With respect to property of the estate not otherwise exempt by other provisions, a debtor should be permitted to retain up to \$20,000 in value in any form. A debtor who claims no homestead exemption should be permitted to exempt an additional \$15,000 of property in any form.

**1.2.4** *All professionally-prescribed medical devices and health aids necessary for the health and maintenance of the debtor or a dependent of the debtor should be exempt.*

**1.2.5** *Rights to Receive Benefits and Payments*

All funds held directly or indirectly in a trust that is exempt from federal income tax pursuant to sections 408 or 501(a) of the Internal Revenue Code should be exempt.

**1.2.6** *Rights to Payments*

Rights to receive future payments (*e.g.*, social security benefits, life insurance) should be exempt, and the debtor's right to receive an award under a crime victim's reparations law or payment for a personal bodily injury claim of the debtor or the debtor's dependents should be exempt.

- 1.3.1** 11 U.S.C. § 524(c) should be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of title 11, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of their perfection, the debtor has provided all information requested in the motion for approval of the agreement, and the agreement conforms with all other requirements of subsection (c).

Section 524(d) should be amended to delineate the circumstances under which a hearing is not required as a prerequisite to a court approving an agreement of the kind specified in section 524(c): a hearing will not be required when the debtor was represented by counsel in negotiations on the agreement and the debtor's attorney has signed the affidavit as provided in section 524(c), and a party in interest has not requested a judicial valuation of the collateral that is the subject of the agreement. If one or more of the foregoing requirements is not met, or in the court's discretion, the court shall conduct a hearing to determine whether an agreement that meets all of the requirements of subsection (c) should be approved. Court approval of an agreement signifies that the court has determined that the agreement is in the best interest of the debtor and the debtor's dependents and does not impose undue hardship on the debtor and the debtor's dependents in light of the debtor's income and expenses.

The Commission recommends that the Advisory Committee on Bankruptcy Rules of the Judicial Conference prescribe a form motion for approval of reaffirmation agreements that contains information enabling the court and the parties to determine the propriety of the agreement. Approval of the motion would not entail a separate order of the court.

- 1.3.2** An additional subsection should be added to section 524 to provide that the court shall grant judgment in favor of an individual who has received a discharge under section 727, 1141, 1228, or 1328 of this title for costs and attorneys fees, plus treble damages, from a creditor who threatens, files suit, or otherwise seeks to collect any debt that was discharged in bankruptcy and was not the subject of an agreement in accordance with subsections (c) and (d) of section 524.

**1.3.3** *No Ride-Through*

Section 521(2) should be amended to clarify that a debtor with consumer debts that are secured, as determined by the provisions of title 11, by property of the estate must redeem the property or obtain court approval of an agreement under section 524(c) of title 11 in order to retain the property postdischarge, except for a security interest in real or personal property that is the debtor's principal residence.

**1.3.4** *Security Interests in Household Goods*

**Household Goods Worth Less Than \$500**

Section 522(f) should provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependent of the debtor in household furnishings, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry, implements, professional books, tools of the trade or professionally prescribed health aids for the debtor or a member of the debtor's household must petition the bankruptcy court for continued recognition of the security interest. The court shall hold a hearing to value each item covered by the creditor's petition. If the value of the item is less than \$500, the petition shall not be granted; if the value is \$500 or greater, the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13.

**1.3.5** *Characterization of Rent-to-Own Transactions*

Consumer rent-to-own transactions should be characterized in bankruptcy as installment sales contracts.

**1.4.1** *Credit Card Debt*

Except for credit card debts that are excepted from discharge under section 523(a)(2)(B) (for materially false written statements respecting the debtor's financial condition) and section 523(a)(14), (debts incurred to pay nondischargeable taxes to the United States), debts incurred on a credit card issued to the debtor that did not exceed the debtor's credit limit should be dischargeable unless they were incurred within 30 days before the order for relief under title 11.

**1.4.2**    *Debts Incurred to Pay Nondischargeable Federal Tax Obligations*

**Section 523(a)(14) should remain unchanged to except from discharge debts incurred for federal taxes that would be nondischargeable under section 523(a)(1).**

**1.4.3**    *Criminal Restitution Orders*

**Section 523(a)(13) should be expanded to apply to all criminal restitution orders.**

**1.4.4**    *Family Support Obligations*

**Sections 523(a)(5), (a)(15), and (a)(18) should be combined. The revised 523(a)(5) should provide that all debts actually in the nature of support, whether they have been denominated in a prior court order as alimony, maintenance, support, property settlements, or otherwise, are nondischargeable. In addition, debts owed under state law to a state or municipality in the nature of support would be nondischargeable in all chapters.**

**1.4.5**    *Dischargeability of Student Loans*

**Section 523(a)(8) should be repealed.**

**1.4.6**    *Issue Preclusive Effect of True Defaults*

**For complaints to establish nondischargeability on grounds set forth in section 523(c), the Bankruptcy Code should clarify that issues that were not actually litigated and necessary to a prior judgment shall not be given preclusive effect.**

**1.4.7**    *Vicarious Liability*

**Section 523(c) should be amended such that intentional action by a wrongdoer who is not the debtor cannot be imputed to the debtor.**

**1.4.8**    *Effect of Lack of Notice on Time to Bring Objection to Discharge*

**Creditors that did not receive notice of a bankruptcy should get an extension of time to file an objection to or seek revocation of a discharge.**

**1.4.9**     *Settlement and Dismissal of Objections to Discharge*

Section 727 should be amended to provide that (a) any complaint objecting to discharge may be dismissed on motion of the plaintiff only after giving notice to the United States trustee, the case trustee and all creditors entitled to notice, advising them of an opportunity to substitute as plaintiff in the action; (b) any motion to dismiss a complaint objecting to discharge must be accompanied by an affidavit of the moving party disclosing all consideration given or promised to be given by the debtor in connection with dismissal of the complaint; and (c) if the debtor has given or promised to give consideration in connection with dismissal of the complaint, the complaint may not be dismissed unless the consideration benefits the estate generally.

**1.5.1**     *Home Mortgages*

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

**1.5.2**     *Valuation*

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

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

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

**1.5.4**     *Unsecured Debt*

Payments on unsecured debt should be determined by guidelines based on a graduated percentage of the debtor's income, subject to upward adjustment to meet the section 1325(a)(4) requirement that creditors receive at least the present value of whatever they would have received in a Chapter 7. The trustee or an unsecured creditor should be

authorized to file an objection to any plan that deviates from the guidelines, and a court would determine whether the deviation was appropriate in light of all the circumstances.

### **1.5.5** *Consequences of Incomplete Payment Plans*

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

Section 362 should be amended to provide that the filing of a petition by an individual does not operate as a stay if the individual has filed two or more petitions for relief under title 11 within six years of filing the instant petition for relief and if the individual has been a debtor in a bankruptcy case within 180 days prior to the instant petition for relief. On the request of the debtor, after notice and a hearing, the court may impose a stay for cause shown, subject to such conditions and modifications as the court may impose.

### **1.5.6** *In Rem Orders*

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

After notice and a hearing, a bankruptcy court should be empowered to issue *in rem* orders barring the application of a future automatic stay to identified property of the estate for a period of up to six years when a party could show that the debtor had transferred such real property or leasehold interests or fractional shares of property or leasehold interests to avoid creditor foreclosure or eviction. A subsequent owner of the property or tenant of the leasehold who files for bankruptcy (or the same owner or holder in a subsequent filing) should be permitted to petition the bankruptcy court for the

imposition of a stay to protect property of the estate, which the court would be required to grant to protect innocent parties who were not a part of a scheme to transfer the property to hinder foreclosure or eviction.

**1.5.7** *Retention of the “Superdischarge”*

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

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

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