

**APPENDIX G**

**CONSUMER BANKRUPTCY**

## **APPENDIX G-1.a**

### **American Bankruptcy Institute Consumer Bankruptcy Reform Forum Report**

**ABI CONSUMER BANKRUPTCY REFORM FORUM**

**SUMMARY AND REPORT ON OPTIONS**

In January, the American Bankruptcy Institute sponsored the Consumer Bankruptcy Reform Forum, a gathering of about 50 practitioners, judges, academics and others representing the views of both debtors and creditors. The Forum began a spirited dialogue on the existing problems in consumer cases and helped create a framework for the identification of areas for reform. From the outset, a goal has been to create a process, rather than to produce a specific set of proposals. Throughout, the focus has been on those areas where debtors and creditors could find agreement.

To continue the work initiated in January, the ABI established a representative steering committee to focus on those issues where there were possibilities of consensus. The steering committee, comprised of Honorable William Brown, Ken Crone, Saul Eisen, Hank Hildebrand, Steve Holiga, Richardo Kilpatrick, Gary Klein, Bob Mitsch, Prof. Jeff Morris, Ike Shulman and Henry Sommer, met a number of times by telephone conferences and at the Bankruptcy Review Commission

("BRC") meetings in furtherance of its stated goal. Through the efforts of the steering committee, a number of issues were highlighted for review. The issues were as follows: Default Discharge, Chapter 13 Superdischarge, Credit Report Forum, Repeat Filings, Disposable Income, Treatment of Rent-to-Own Contracts and Stripdown of Mortgages/Interest on Arrears. The steering committee and sub-groups prepared and circulated specific memorandums on each one of the issue areas.

The ABI forwarded to all original participants an invitation to attend a meeting scheduled for May 15, 1997, to discuss the memos and to continue the Forum's work. The Forum's second meeting was held May 15, 1997, from 8:00 a.m. - 12:00 p.m., in conjunction with the ABI's Annual Spring Meeting in Washington D.C. Approximately fifty percent (50%) of the original invitees from the January meeting attended the second meeting, along with individuals who had come to Washington to attend either the ABI Annual Spring Meeting or the Bankruptcy Review Commission's May meeting. The discussions in all areas were very active and lively.

This report was prepared by Professor Jeffrey Morris, Judge Eugene Wedoff, Richardo Kilpatrick and Samuel J. Gerdano, ABI Executive Director, to summarize the events as they transpired at the meeting. <sup>1</sup>

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<sup>1</sup> Not surprisingly, there remain areas of disagreement, even on options where parties narrowed their differences. Attached to this summary are letters from two Forum participants, Jill M. Sturtevant of Bank of America and Dean S. Cooper of Freddie Mac, critical of certain options.

### **Topic 1 -- Default Discharge Option for Failing Chapter 13 Cases**

Often when a debtor seeks Chapter 13 relief, that debtor might have qualified for a "no asset" Chapter 7 discharge at the outset. If the debtor elects a Chapter 13 and the Chapter 13 plan subsequently fails, current law allows the debtor to voluntarily dismiss the case, elect to convert the case, or the case is dismissed upon the motion of a party in interest, usually the trustee. If the Chapter 13 is dismissed, the debtor receives no discharge. If the case is converted, the debtor normally incurs additional attorney's fees and filing fees, must file new schedules and statements and must attend a new meeting of creditors. This is so even in a "no asset" case.

The existing system deprives many debtors of a discharge to which they would have been entitled had they originally filed a Chapter 7, despite the fact that they attempted a repayment plan. This skews two policies that Congress has articulated - (1) to encourage people to attempt a repayment plan and (2) to provide debtors with a "fresh start".

The option below would improve current law in a number of ways. First, it would provide a discharge for numerous Chapter 13 debtors who attempt but fail to complete payment plans to creditors, leaving them in at least as good a position as those debtors who elect Chapter 7 with no payment to creditors. Second, because of the increased number of debtors who will obtain such a discharge, the number of bankruptcy filings nationwide will be reduced, since a certain portion of refilings to obtain the discharge will not be necessary. Third, Chapter 7 administrative costs will be avoided for "no asset" cases, thereby increasing the efficiency of the system.

### ***Option***

As under existing law, a debtor may elect to dismiss a Chapter 13 case at any time, unless the case was previously converted to Chapter 13 from another Chapter, in which case the debtor may seek court approval of a dismissal.

In the event the debtor fails to comply with a confirmed Chapter 13 Plan, the trustee or any other party in interest may file a noticed motion to have the case closed. Upon motion to close, the moving party (usually the trustee) must disclose, (1) whether the debtor would have been entitled to a discharge of debts under Section 727 had the debtor filed a Chapter 7 petition, or (2) whether the debtor has met the "best interest" test by repaying a sufficient amount to unsecured creditors during the Chapter 13 Plan. Notice of a hearing would be provided to all parties in interest of the motion to close the case with a basic discharge (equivalent to a current Chapter 7 discharge). This notice would also contain the dates set for parties to bring 523(a) and 727 complaints. No bar date would be set for claims to be filed in these cases, since no assets would be administered by a Chapter 7 trustee. Unless a party objected (arguing that the estate should be administered under Chapter 7), and a 727 complaint was filed, or the debtor voluntarily dismissed the case, the motion would be approved by the court at the hearing and the discharge would be entered. At all times during the process, the debtor would retain the right to dismiss the case. If a party filed a 523(a) complaint, the discharge would still be entered with regard to other creditors, and the 523(a) complaint would proceed as under current law.

If the trustee perceives that an unconsummated Chapter 13 case is no longer being funded and that the case should be administered because there are assets sufficient to

provide distribution to creditors, the trustee shall move to convert the case to Chapter 7, unless the administration would produce only a nominal result, in which case the trustee shall move to dismiss the case. Unless the case were dismissed by the debtor or the trustee, the case would be converted to Chapter 7 for administration or disposition. Notice of the motion to convert would also contain the dates set for parties to bring 523(a) and 727 complaints as well as the bar date for claims to be filed.

A debtor could contest the motion to close or convert and would have the right to modify the Chapter 13 Plan or propose a mechanism to cure the Chapter 13 Plan default up to the time that the objection period had passed. If a case were converted, the debtor would be credited for payments to secured creditors as provided under current law (Section 348).

If the debtor fails to obtain confirmation of a plan, the option of closing with discharge would not be available. The debtor could dismiss or convert to Chapter 7, and any party in interest could seek to have the case dismissed or converted.

Current protections against involuntary conversion for farmers would be maintained.

### ***Discussion***

There was active discussion of this option with some participants indicating some questions that had to be addressed prior to any consensus being reached on this concept.

The questions were as follows:

1. Property of the estate -- With the effect of 348(f), would this proposal allow a debtor that had obtained a windfall to exercise the right to a default discharge while having the ability to repay creditors?

2. What would constitute property of the estate in a converted case?
3. Would the debtor receive credit for payments made during the plan in the event of a conversion to be applied against secured claims?
4. What would happen with post-petition appreciation of properties?
5. How can this mechanism be crafted in a fashion to avoid misuse by debtors? (i.e., a pay down of secured debt, then use of the default discharge).
6. There was a question as to whether there should be a good faith requirement engrafted upon this new right.
7. In the event that the BRC recommendation for an absolute prohibition against refiling softened, what would happen in the event of repeat filings?

In summary, there was some general support among both creditors' and debtors' representatives for this option.

## **Topic 2 - Chapter 13 Superdischarge**

### ***Stop Further Erosion of the Superdischarge***

The Chapter 13 superdischarge was intended to be an important incentive to encourage debtors to elect Chapter 13. Debtors who could propose a confirmable plan would be able to discharge almost all debts by paying all unsecured creditors a pro rata dividend. However, since 1978 the superdischarge has been eroded through piecemeal amendments to the Code, making Chapter 13 less attractive to debtors. These debtors, unable to solve their financial problems through Chapter 13, are more likely to find it necessary to file Chapter 7, resulting in no dividend to most unsecured creditors.

Proposals have recently been made to cut back even further on the superdischarge, specifically regarding certain tax debts. These proposals have been advanced by tax



authorities, notwithstanding the fact that Chapter 13 has permitted the recovery of substantial tax revenues at low collection cost. Further restrictions on the superdischarge will lessen Chapter 13 as a viable option for many more debtors, thus limiting the ability of those debtors to obtain financial rehabilitation and eliminating repayments to most of their unsecured creditors.

Giving additional classes of creditors nondischargeable status harms the interest of both debtors and most general unsecured creditors. Therefore, it is suggested that no further restrictions on the Chapter 13 superdischarge be enacted.

### ***Restore the Superdischarge for Student Loans?***

Until 1990 most student loans were dischargeable in Chapter 13, providing an incentive for debtors to choose Chapter 13. That year, however, Congress enacted new legislation making most student loans nondischargeable in 13. This legislation never underwent scrutiny in the Judiciary Committees of Congress, thus depriving interested parties of the ability to comment on the effects of such a change on debtors and creditors alike. Many debtors today simply have no way to repay their student loans from their current income, and also have little prospect for significant financial improvement in the near future. In some cases these debtors attended trade schools, after unscrupulous sales tactics by those schools.

To provide these debtors with a chance for financial rehabilitation and to encourage more Chapter 13 plans where all unsecured creditors share in a debtor's repayment, it is recommended that the superdischarge be restored for student loans in Chapter 13 cases.

## ***Discussion***

The Forum was in complete consensus that there should be no further erosion of the Chapter 13 superdischarge.

A substantial amount of time was spent discussing the elimination of student loans, both as it relates to the Chapter 13 superdischarge and the dischargeability sections under 11 U.S.C. § 523(a). There was a concurrence on the deletion of student loans, from 523(a)(8).

Concern was expressed over the other types of obligations, HEAL loans and others, and the need to make dischargeable those student loans as well in the event that there was a deletion of the student loan discharge prohibition in 1328(a).

## **Topic 3 -- Credit Bureau Reform**

A subgroup of the steering committee recommended the following:

1. Bankruptcies must be reported by Chapter.
2. Completed Chapter 13 plans must be reported by the percentage of the unsecured debt which was repaid. The reporting on this would have to be forwarded by the Chapter 13 trustees to the credit bureaus.
3. If the debtor completes a Chapter 13 and the credit reporting on all the debts included in the bankruptcy plan has expired, the credit bureau should delete the reporting on various debts and delete the Chapter 13 Bankruptcy, as well.
4. Completion of a consumer finance education program would also be recorded in the credit bureau history.

## ***Discussion***

After active discussion, there was consensus that points 1, 2 and 4 of the Credit Bureau Reform options should be adopted. Point 3 of the options was discussed in depth, and there were concerns expressed that the deletion of the various debts would, in some cases, leave an empty file; a term utilized in the industry to indicate that a person has no credit history. There was discussion as to whether the deletion of the information in total was beneficial or detrimental to the debtors. Some felt that it would be more beneficial for a debtor to have the information displayed in their credit report indicating that there had been repayment on obligations through a Chapter 13 bankruptcy. The creditors' representatives were also concerned that the deletion of this information would not leave enough information available for a creditor to make a knowledgeable decision on whether to grant or deny an extension of credit. It was indicated that in many instances, credit grantors would extend credit with the information proposed to be deleted, and it would be unfair to remove this information and not make it available for their consideration.

As a result of the concerns voiced by both sides of the equation, debtors as well as creditors, point 3 was deleted from the list of options.

The discussions then turned to consumer education. There was consensus and support for consumer education. The parties to the Forum specifically requested that we avoid indicating whether the education should be mandatory or optional.

There was also consensus and support for credit rehabilitation programs, again, with the proviso that there be no indication whether it should be mandatory or optional.

#### **Topic 4 - Option on Repeat Filings**

The goals of an effort to deal with serial bankruptcy filings are:

1. To sort out the abusive cases from the nonabusive cases.
2. To quickly deny the automatic stay to debtors who file abusive cases, thereby also eliminating the incentive to file such cases.
3. To avoid imposing costs on debtors who are not filing abusive cases that might make it more difficult or even impossible for them to obtain needed relief.
4. To avoid imposing costs on creditors or lessors who are delayed from exercising their rights by abusive bankruptcy cases.

It was agreed that the barriers to serial filings should not be applicable to the second bankruptcy case a debtor files. It was our consensus that the second case is far more often legitimate than abusive. Even in the situation where, in hindsight, it becomes clear the second case was abusive, such a finding can rarely be determined when the second case is filed. This would not prevent a creditor or lessor who wishes to allege an abuse in a second case from filing a motion for relief from the stay or a motion to dismiss, and even seeking expedited relief, as that creditor or lessor can do under current law.

However, if a debtor files a third case within a five year period, and that case is filed within 180 days of the dismissal of the second case, a new barrier would be erected. In such a case, the automatic stay would terminate 15 days from the petition filing unless no objection was filed to the continuation of the stay by any creditor, lessor, or the trustee. (Calendaring the hearing would be left to local practice.) Thus, creditors and lessors would have a quick and easy way to trigger a prompt review of the debtor's filing, and debtors would have little incentive to file a case that could not be justified, since the stay

would be lost almost immediately.

If no objection to the debtor's motion was filed, the court would continue the stay without a hearing, subject to current relief from stay procedures. If an objection was filed, the debtor would have the burden at the hearing of proving that there was a reasonable prospect of completing a feasible plan. Absent such a finding, the stay would not be continued as to the objecting creditor or lessor. If the trustee objected, the court could consider factors such as any change in circumstances since the prior cases, level of effort in the prior cases, amount of arrears, reasons for failure of prior cases, the debtor's honesty with the court, and differences in Chapter 13 plans between the prior cases and the current case.

For any bankruptcy case filed by a debtor after the third case within a five year period, there would be no automatic stay. The debtor could seek a stay from the bankruptcy court and would have the same burden of proof as in the case.

### ***Court's Power to Issue in Rem Orders***

The steering committee agreed that the bankruptcy court must have a limited power to issue *in rem* orders granting relief from the stay with respect to a particular property for future cases filed by debtors other than the debtor in the case before it. This power is necessary in order to prevent schemes in which property is transferred and subdivided for the purpose of repeated bankruptcy filings by different debtors, invoking a new automatic stay with respect to the property in each case.

Under this option the court would have the power, on motion of a creditor or real

property lessor, to issue an *in rem* order that would make the automatic stay inapplicable to particular property in a subsequent bankruptcy case.

This order could be issued only upon a finding that the property had been transferred after a prior bankruptcy case in which the stay was applicable to the property for the purpose of the transferee obtaining an automatic stay that could not otherwise be obtained with respect to the property (for example, under the first part of this proposal, if the transferor had filed two prior cases and could not make the showing necessary to obtain a stay in a subsequent case.) The order could be entered only after notice to all known entities having an interest in the property and an opportunity for a hearing.

The order could be recorded by the moving party in the appropriate registry for real estate, and if recorded would be deemed constructive notice of its terms to any transferee who received an interest in the property after the order was recorded. The order would remain effective until the earlier of (1) the expiration of six years from the date of the order or (2) the moving party realizing its collateral or, in the case of the lessor, obtaining possession of the property.

A transferee or co-owner of the property who is innocent of any scheme to abuse the automatic stay could move for relief from the order. Such relief could be granted by the court in its discretion after notice to the party that sought the order and a hearing.

### ***Discussion***

This was probably the most controversial of the options contained within the steering committee's submissions. After discussion, the following areas were highlighted

as problems:

1. Definition of abusive cases.
2. The effect on mortgagees in foreclosing in a second filing within the mechanisms contemplated by the proposal.
3. Many participants felt that the proposal was much too liberal.
4. Many felt that the proposal was much too restrictive.

As is obvious from this summary, this is still an issue that polarizes the debtor and creditor communities and consensus was not possible.

The area which received the most acceptance was in bolstering the court's power to issue *in rem* orders, where appropriate.

### **Topic 5 - Disposable Income**

Presently, a debtor must dedicate "all disposable income" to fund a Chapter 13 plan upon the application of the trustee or an unsecured creditor (see § 1325(b)). A debtor may avoid this obligation by proposing a plan which satisfies all unsecured claims in full, within a three year period. Issues have been raised as to what types of expenses are to be included in a debtor's budget, since "all disposable income" is statutorily defined as funds which are not "reasonably necessary to be expended...for the maintenance or support of the debtor or a dependent of the debtor." Courts have disagreed as to what types of expenses are appropriate or "reasonably necessary." Courts have also applied varying standards as to the amount of expenses which are appropriate.

One proposal under serious consideration is the establishment of a standard

template which fixes the amount of funds which a debtor must dedicate to pay to unsecured claim holders. The standard template would be national in scope and adjusted for family size and geographic differences.

At the January ABI Forum, there was a general (though not unanimous) feeling that, with some exceptions, the idea of paying "all disposable income," determined on a case-by-case basis works reasonably well, providing flexibility for debtors in fashioning Chapter 13 relief around their own circumstances, subject to the scrutiny of trustees and creditors.

The participants at the ABI Forum have articulated problems, however, with the uniformity of the application of the § 1325(b) test. Judges can differ radically on what might be reasonable and necessary.

### ***Options***

The definition of disposable income will still be those funds not reasonably necessary for the maintenance and support of the debtor and the debtor's household dependents. The debtor would list expenses incurred in several broad categories which would be presumptively "necessary", and the reasonableness could be subject to challenge. These categories are:

- ◆ Food expense
- ◆ Housing costs (and housing related expenses)
- ◆ Clothing
- ◆ Laundry and cleaning
- ◆ Utilities and telephone
- ◆ Medical expenses



- ◆ Insurance
- ◆ Taxes
- ◆ Support
- ◆ Transportation

Whether such expenses are reasonable would depend upon the reasonable needs of the debtor's family and the reasonable living expenses of a family of similar size, with similar income living in the same geographic area. Any party challenging the reasonableness of such expenses by a debtor's family would bear the burden of proof to demonstrate non-reasonableness.

For a self-employed debtor or a debtor engaged in business, expenses related to the production of income would be presumptively necessary. Whether the expenses are reasonable would depend upon the expenses incurred by similar businesses in the same geographic area.

If a debtor incurs other types of expenses (tuition costs, entertainment, gifts, etc.) such could be reasonably necessary, but, on request of the trustee or any unsecured creditor, the debtor would bear the burden of proof to demonstrate the reasonableness and the necessity of the proposed expense.

If the debtor's plan meets the requirements of § 1325(b), confirmation of the plan should not be denied solely because the plan fails to meet any minimum payment requirement beyond that required by § 1325(a)(4).

### ***Discussion***

Although this topic was discussed in depth, there was no consensus on the

proposal. The comments ranged from, "This is no different than the system that exists right now" to "This creates a basis to lie as the list presumed to be necessary for the maintenance and support of a debtor or dependent encourages deception."

A substantial portion of the attendees of the Forum indicated a desire to continue the status quo with no changes, indicating that the system as it exists allows for those local and geographical variances that are necessary when dealing with budgets in Chapter 13's.

The remainder of the individuals either desired very flexible guidelines or stringent templates.

#### **Topic 6 - Treatment of Rent-to-Own Contracts**

There has been continuing debate over how to treat rent-to-own contracts which do not fit neatly into the definition of "lease" or the definition of "sale" outside of bankruptcy. Many instances were cited where the use of these contracts have created problems throughout the country for low income consumers. In rent-to-own transactions, consumers enter into agreements to rent various household and personal items for low payments over extended terms designed to, in essence, purchase the item through the agreement. These rent-to-own contracts appear to be an attempt, by those who engage in this practice, to avoid various state laws regulating interest rates and lending practices.

These same issues arise in bankruptcy cases with varying results. The majority of courts have treated these obligations as installment sales subject to Sections 722 and 1325. A minority of courts have treated these as "true leases".

It was agreed by consensus that these types of obligations should be re-

characterized as installment sales to allow the treatment as afforded under the applicable provisions of the Code. The re-characterization of rent-to-own contracts must be crafted in a manner to avoid any negative impact on "true leases".

It is possible that the simplest method of dealing with the problem in bankruptcy is to treat the transaction as an installment sale, regardless of its characterization under state law, for purposes of bankruptcy. This could be accomplished by an amendment in Section 365, or elsewhere, providing that in a case where an individual debtor is the lessee of consumer goods other than a motor vehicle, the debtor may have the transaction considered a sale, according the lessor an allowed secured claim in the amount of the value of the property or the present value of the remaining payments, whichever is less. The lessor would have a deficiency claim allowable as an unsecured claim for the present value of the remaining payments due under the lease minus the allowed amount of the lessor's allowed secured claim.

The most practical way of doing this may be to amend the definition of "security interest" to include the rights arising out of rent-to-own transactions. The transactions would then be subject to the statement of intentions section in Chapter 7, Section 521(2) and the redemption provision in Section 722. Treating these transactions as security interests rather than leases is also consistent with the concept of equality of distribution. By contrast, if rent-to-own contracts are treated as leases, it skews distribution within Chapter 13 proceedings to the detriment of unsecured and secured claim holders.

## ***Discussion***

This option, with limited discussion, was accepted by consensus. The only remaining issue that most felt should be addressed was the determination of the sales price to allow bifurcation and treatment of the claim.

## **Topic 7 - Stripdown of Mortgages/Interest on Arrears**

### ***Stripdown of Mortgages/Modification***

The protections of current Section 1322(b)(2) would be retained for most first mortgages secured by residential real estate. The revised section would protect mortgage lenders from stripdown (and other nonconsensual modification) of secured claims based on mortgages used to purchase (or construct) the debtor's primary residence. Refinancing of those mortgages would also be protected unless the annual percentage rate on the refinanced loan (or the index on a variable rate mortgage) is more than 5% over the prime rate on the date the loan is made. In addition, if the debtor has moved out of the mortgaged residence within 180 days prior to filing bankruptcy, the specified protections against stripdown and modification would apply.

As under current law, deceleration and cure of a mortgage default consistent with the requirements of the Code would not be considered a mortgage modification.

Modifications of protected mortgages involving capitalization of the arrears and reamortization of the resulting balance would be allowed by consent of the parties, regardless of state law. Payments under such a modified mortgage would be made directly to the mortgagee. If a consensual modification agreement is filed with the court

at the time of that modification, the secured creditor would be presumptively entitled to relief from stay upon a rebuttable showing that the debtor is more than 60 days behind on payments under the mortgage as modified.

### ***Interest on Arrears***

Current Section 1322(e) would be expanded to all mortgages, regardless of their date. Interest on arrears would be allowed only when permitted by contract and state law, only to the extent of the principal amount in arrears, and only upon demand by the creditor.

### ***Discussion***

The principle of lien stripping was widely accepted under circumstances where a creditor obtained a security interest in property, while consciously and concurrently granting a loan in excess of the value of the property. The controversy ensued when attempts were made to discuss the mechanism and determination of who should fall within the purview of the stripdown provisions. Creditors' representatives posited the hypothetical that existed in California, Texas and Massachusetts when property values plummeted during their recessions and indicated that those creditors who, in good faith, granted loans that were fully secured should not be subject to stripdown. Creditors' representatives further disagreed with the proposal in that it did not cover secondary obligations such as equity lines or second mortgages. No consensus was reached.