NUTS AND BOLTS OF CONSUMER BANKRUPTCY

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LESSON 1: INTRODUCTION

INTRODUCTION

This article is intended to provide the public with information concerning consumer bankruptcy.

This paper is also intended to provide the attorney who never files a bankruptcy, as well as the attorney whose practice is primarily bankruptcy, with useful information concerning Chapter 7, and Chapter 13 of Title 11 U.S.C. - the Bankruptcy Code. Attorneys who deal in family law, criminal law, administrative law, real estate, taxation, creditor's rights, find themselves frequently confronted with bankruptcy issues. For those attorneys whose practice is primarily bankruptcy, this paper will provide them with concise information that will help them in their daily practices. The references to sections in this course are to sections of the bankruptcy code.

When an individual or married couple finds it impossible to pay their bills, one solution is to file a chapter 7 or a chapter 13 bankruptcy. Chapter 7 allows a debtor to eliminate or discharge certain debts and in most cases retain all of his assets. Chapter 13 allows a debtor to pay his creditors under a court-approved plan.

When a discharge order is issued by the court pursuant to a bankruptcy petition being filed, the dischargeable debts and claims are discharged. Some debts are not dischargeable under chapter 7, such as child or spousal support, most income taxes, certain student loans, government fines, and debts incurred due to drunk driving or fraud. These types of debts are usually handled through a chapter 13 bankruptcy. The general rule in chapter 7 is that unsecured debts are dischargeable and secured debts are not dischargeable. If the debt is unsecured, the creditor does not have a lien or a security interest in any of the debtor's property. When the bankruptcy is completed the unsecured creditor is prevented from attempting to collect the debt.

Secured creditors, those who have made loans on such items as homes, automobiles, or furniture, are prevented from foreclosing or repossessing the items unless they first obtain permission from the bankruptcy court. If one desires to keep an item securing a debt, he will need to continue making the payments on the debt either directly or through the chapter 13 trustee.

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LESSON 2: BASIC BANKRUPTCY ISSUES

AUTOMATIC STAY

Section 362 provides that the filing of a bankruptcy creates an automatic stay. This is one of the main debtor protections provided by the bankruptcy code. This stay stops all collection efforts, law suits (even those in process at the time of filing), foreclosure actions, harassment, acts to seize or place liens on property, etc. However, the automatic stay does not apply to criminal actions or criminal proceedings against the bankrupt. A party in interest may request the court to terminate, annul, or modify the stay if it can be shown that (1) there is a lack of adequate protection, or (2) the debtor has no equity in the property, and such property is not necessary for an effective reorganization.

If a debtor has had another case pending within the preceding 1-year period but was dismissed, other than a case refilled under a chapter other than chapter 7 after dismissal, the stay shall terminate with respect to the debtor on the 30th day after the filing of the later case. However, on the motion of a party in interest for continuation of the automatic stay and upon notice and a hearing, the court may extend the stay. The hearing to extend the stay must be completed before the expiration of the 30-day period. The party in interest must show the court that the filing of the later case is in good faith.

If the debtor has had 2 or more cases pending within the previous year but were dismissed, the stay shall not go into effect upon the filing of the later case. However, if, within 30 days after the filing of the later case, a party in interest may request the court to order the stay to take effect. It must be shown that the later case is filed in good faith.

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EXEMPT VERSUS NON - EXEMPT PROPERTY

When a bankruptcy is filed the debtor must classify his assets as either exempt or non-exempt. Important to every bankruptcy case is a determination before the case is filed as to whether or not the debtor will lose any property. The bankruptcy code provides that certain property can be claimed as exempt and retained by the debtor. Non-exempt property may be sold by the bankruptcy trustee for payment to creditors. It is important to note the value of the property is the net value. Amounts for liens or loans properly recorded against the property will reduce the value of the debtor's interest in the property by the amount of these liens. This is often the case with items such as houses and cars. The word "value" means fair market value as of the date of the filing of the petition.

Section 522 of 11 U.S.C. sets forth what property may be classified as exempt if the federal exemptions are elected to be used by the debtor. Section 522 (b) (2) (a) allows a debtor to chose to exempt property as provided by the state of his domicile rather than use the federal exemptions. The choice made by the debtor will be based upon the composition of the debtor's assets. For example, Texas has no monetary limitation for the homestead exemption. However, the federal exemption limitation is much less. Most states have opted-out of the federal exemption. In those states debtors must use the state exemptions. Most states allow for an exemption of a home, household goods, clothing, qualified retirement plans, and vehicles. These exemptions have monetary limits. Federal exemptions for household goods are clothing, furniture, appliances, 1 radio, 1 television, 1 VCR, linens, china, crockery, kitchenware, educational materials and educational equipment primarily for the use of minor dependent children of the debtor, medical equipment and supplies, furniture exclusively for the use of minor children, or elderly or disabled dependents of the debtor, personal effects (including the toys and hobby equipment of minor dependent children and wedding rings), and, 1 personal computer and related equipment.

Federal exemptions also have what is referred to as a "wild card" exemption. This allows property of any kind, including cash, income tax refunds, and boats, to be exempted. The amount of the exemption is limited and is based to a large extent upon the equity a debtor has in the homestead.

Pre-bankruptcy planning – can a debtor convert non-exempt property to exempt property and get away with it? One court decision involved a debtor who sold non-exempt stock and used the proceeds to pay down on his exempt homestead debt immediately before filing a chapter 7. A creditor objected to the claim of exemption and the court held in favor of the creditor. The court said, "The status of bankruptcy planning is in a state of utter confusion. The conversion of non-exempt assets into exempt assets on the eve of bankruptcy is not, standing alone, fraudulent and the payment of regular monthly payments of the debtor's homestead in the usual manner of living of the bankrupt, are perfectly appropriate. However the deliberate enlargement of exemptions out of the usual and customary manner of living and in contemplation of bankruptcy is cheating which shocks one's conscience and brings the whole bankruptcy process into disrepute. The conversion of non-exempt property into exempt property should be permitted only within limits and outright fraudulent bankruptcy planning that exceeds those limits should not be permitted.” [In re Schwarb 150 B.R. 470]. In another case [In re Coates, 242 B.R. 901] the debtors used $45,000 of non-exempt funds to pay off the debt on their homestead only 18 days before filing a chapter 7 bankruptcy. The chapter 7 trustee objected to the homestead exemption contending the debtors' action constituted a fraud on the creditors. The court disagreed with the trustee and stated, “A disposition of property subject to execution for the purpose of procuring a homestead would not be deemed a fraud upon creditors. The head of a family has the right to invest his property in a homestead, and creditors without lien cannot complain that in doing so he uses property that could be levied on for debt, even though he is in failing circumstances.”

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JOINT CASES

Section 302 allows a husband and wife to join in the filing of a bankruptcy petition. Most consumer bankruptcy filings involving married couples are filed as joint cases since no bankruptcy protection is afforded a spouse who does not join in the filing. If only one spouse files, the debtor cannot later add his spouse as a debtor. The non-filing spouse could however file his or her separate bankruptcy. The courts have held that there is no authority in the code for adding a co-debtor and to allow the addition would contribute to potential confusion and prejudice to creditors. [In re Walker 169 B.R. 391].

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HOW LONG MAY A DEBTOR TAKE TO PAY CREDITORS UNDER A CHAPTER 13?

Section 1322 (c) provides that, if the debtor's income is equal to or exceeds the median family income of the applicable state the plan may not be longer than 5 years. If the income is less than the median income, the plan may not be longer than 3 years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than5 years. The problem here is that the code does not say when the period of time begins. Does it begin with the date of filing the petition, the date of confirmation of the plan, the date the first payment was due, or some other date? A creditor objected to a debtor's chapter 13 plan because it provided for the last payment to be made after five years from the date of filing the chapter 13, but made within five years from the date of confirmation of the plan. The court held for the debtor and held that the most logical date is the confirmation date. The court based its decision on section 1329 (c) which provides that a modified chapter plan may not provide for payments to be made after five years from the time the first payment was due under the original confirmed plan. [In re Matter of Edict 157 B.R. 255].

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MUST THE DEBTOR MEET WITH CREDITORS?

Section 343 states "the debtor shall appear and submit to examination under oath at the meeting of creditors under section 341 (a) …" Are there any exceptions? A debtor husband in a joint chapter 7 requested the court to allow him to be excused from the creditors meeting provided by section 341, because he was in the military and had been ordered out of the country on duty at the time of the meeting. He agreed to answer any questions by written interrogatories instead. The court denied the request and held section 343 was unequivocal and mandatory. [In re Landau 156 B.R. 664]. Some courts have excused the appearance of the debtor under exceptional circumstances such as hospitalization or incarceration.

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LESSON 3: COMMON BANKRUPTCY QUESTIONS

WHAT ABOUT FEDERAL INCOME TAXES?

As the old saying goes, the two things you can't avoid are death and taxes. This is generally true. However, in certain situations taxes may be discharged. Sections 507 and 523 deal with this issue, but are difficult to interpret. Basically what the sections provide is that if, when a bankruptcy is filed, the taxes are over three years old, the tax return has been on file for over two years, and 240 days have passed since the tax was assessed, the taxes may be dischargeable. However, if the internal revenue service (IRS) can prove there was a willful attempt to evade or defeat the tax, the discharge will not be allowed. Some courts have held that a willful attempt to evade or defeat the tax is evidenced by a debtor living beyond his means (vacations, luxury vehicles, etc.) during the time the tax was owed, and thus denied the discharge.

Section 523 (a) (1) (B) (ii) holds that debtor may not obtain a discharge from a tax unless the tax return has been on file at least two years. This filing requirement is not satisfied by the Internal Revenue Service (IRS) filing substitute returns on behalf of the debtor. In re Pierchoski [243 B.R. 639], the chapter 7 debtor sought a discharge of his old taxes. The debtor had filed his Form 1040 tax returns <u>after</u> entering into a stipulation with IRS regarding his tax delinquency, and after IRS had issued formal assessments in the amount of the stipulated tax debt. IRS contended that the debtor's late filing did not qualify as 'returns' for dischargeability purposes since they did not serve any tax related purpose. The debtor, of course, argued otherwise. The Court held for IRS and stated in its opinion, "If a document is to qualify as a bona fide tax return, it must: (1) purport to be a tax return; (2) be executed under penalty of perjury; (3) contain sufficient information to enable calculation of the amount of tax owed; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax laws. If Form 1040 is filed too late to serve a tax purpose or to have any effect at all under the Internal Revenue Code, it cannot as a matter of law qualify as an 'honest and reasonable attempt to satisfy the requirement of the tax laws' and therefore cannot qualify as a tax 'return' for purposes of section 523 (a) (1) (B) (i). A Form 1040 filed after IRS has assessed a taxpayer for unpaid taxes cannot as a matter of law qualify as a bona fide tax return for this reason. Such a filing is too late to have any effect on the ability of IRS to enter an assessment or to collect on it through levy or judicial proceeding and does not affect the taxpayer's civil or criminal liability. The purpose of a tax return is not merely to provide tax information in some form but also to provide it with such uniformity, completeness, and arrangement that the physical task of handling and verifying tax returns may be readily accomplished. Our tax system would implode if taxpayers were permitted to report the correct amount of tax owed after the government has gone to the trouble and expense of determining on its own a taxpayer's tax liability. Both civil and criminal penalties can result if one fails to file a timely tax return. An unjustifiable inconsistency would result if a taxpayer who is subject to both civil and criminal penalties for filing a late return could find a safe harbor under the Bankruptcy Code by having their tax debt discharged by the simple expedient of filing a bankruptcy petition. We therefore shall enter summary judgment in favor of IRS against debtor. His unpaid tax liability to IRS is not discharged."

In a chapter 13, one may be able to arrange for payment of taxes over a period not to exceed five years and in affordable monthly payments rather than what IRS demands. Once a chapter 13 is filed, the IRS cannot garnish wages, seize bank accounts, close a business, perfect a tax lien, or make any other collection efforts for the pre-petition tax debt. However, courts have held that the IRS may offset post-petition refunds against the pre-petition debt. [In re Hudson 168 B.R. 449]. If IRS files a tax lien before the bankruptcy is filed, the tax debt will have to be paid back with interest, to the extent of the equity in the liened assets, regardless of the age of the taxes.

Payroll taxes – taxes withheld from employees for income taxes and social security taxes are subject to different rules. This type of tax is often referred to as a "trust fund" tax; i.e., the withholder is holding the amounts withheld in trust for IRS. This type of debt is never dischargeable, regardless of how old it is. However, there was a case where the IRS failed to file a timely proof of claim in a chapter 13 bankruptcy for payroll taxes withheld by the debtor. The court held the debtor was discharged from the debt when the discharge from the chapter 13 was issued.

If IRS has not filed a lien by the time a chapter 13 bankruptcy is filed, the amount paid back is the amount of taxes, interest, and penalties owed on the date of filing the petition. No post petition interest need be paid to IRS through the chapter 13. If IRS files a tax lien before the chapter 13 is filed, the tax debt will have to be paid back with interest to the extent the debtor has equity in levied assets. A unique question that was presented before the court was if the IRS lien attached to pension benefits to be received in the future. The court held the lien did attach to these future benefits. The court said "upon assessment of a tax, a federal tax lien arises and attaches to all property and rights to property of the taxpayer. Thus, after assessment, the United States had a lien on all property and rights to property of the debtor upon assessment of the taxes against him. The language of the statute is broad and reveals that congress meant to reach every interest in property that a taxpayer might have. Thus, the debtor has a present right to receive payments in the future, which is a right to property to which the tax lien attaches. The right to future benefits exists in the present, and, most importantly, existed on the date of the filing of the petition in bankruptcy. Accordingly, the federal tax lien attached to all of the debtor's rights in the pension benefits, including the right to future payments. The United States, thus, is secured to the extent of the present value of the debtor's retirement benefits."

Section 505 gives the bankruptcy court the authority to determine the amount or legality of a tax unless, prior to the filing, the tax had been contested and adjudicated by a judicial or administrative tribunal of competent jurisdiction.

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MUST IRS PAY PUNITIVE DAMAGES? – YES!

A debtor filed a chapter 13. However, her husband did not join her in the filing. IRS was listed as a creditor and filed a proof of claim. Subsequently IRS filed a lien against the debtor and her husband. The debtor complained to the IRS that the lien was violative of the automatic stay. The IRS then issued a correction listing only the debtor's husband. The next act of IRS was to issue three separate "notices of intent to levy" in both the debtor's and her husband's name. The debtor then sought an order finding IRS in contempt for violation of the automatic stay and asked for attorney's fees and punitive damages. IRS argued that the violation was unintentional and that the notices were addressed to both the debtor and her husband because that is the nomenclature used by the couple on their joint income tax returns. The court held in favor of the debtor and stated, "the IRS argument misses the point. The willfulness requirement refers to the deliberateness of the conduct and the knowledge of the bankruptcy filing, not to a specific intent to violate a court order. The mailing of the 'notices of intent to levy' can only be viewed as willful. After sending notices addressed to both the debtor and her husband, it is not enough for the IRS to say afterwards that it intended only to levy against property of the husband. When there has been a willful violation of the automatic stay, section 362 (h) mandates the award of actual damages, including costs and attorney's fees, and in appropriate circumstances, punitive damages. The court finds that the circumstances of this case warrant an award of punitive damages in the amount of $2,500.00." [In re Gaunt 136 B.R. 736].

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HOMESTEAD - FORECLOSURE AND CHAPTER 13

A foreclosure can be stopped by filing a chapter 13. The bankruptcy can be filed on the day of foreclosure as long as it is before the foreclosure sale. The attorneys for the Mortgage Company and/or the Mortgage Company should be notified of the filing and provided with the bankruptcy case number immediately upon filing in order to prevent the foreclosure sale from proceeding. Also, confirmation of the bankruptcy should be filed in the county where the property is located. The chapter 13 plan may provide for all arrearages on the mortgage to be paid through the plan. Post petition payments are usually made directly by the debtor to the Mortgage Company. If the debtor becomes delinquent in making his post petition payments, the Mortgage Company can file a motion to lift the automatic stay, and if granted by the court, begin foreclosure proceedings. However, there have been cases where the court has allowed the debtor to include some post petition house payments in the chapter 13 plan.

Section 1322 (b) (2) prohibits a debtor from modifying the terms of the mortgage on his homestead. This does not mean that arrearages cannot be paid through the chapter 13 plan as described above. This section does however prevent a debtor from "cramming down" the mortgage. An interesting case involved a husband and wife who used their home as a 'bed and breakfast' and sought to modify the mortgage in their chapter 13. The creditor argued that the debtor's could not modify because of section 1322. The debtor's argued that since the home was not used <u>only</u> as a principal residence they could modify the terms. The court held in favor of the debtor's and stated in its opinion, "There is a continuum of situations in which the mixed-use question might arise. Many homes have a room used for an office or room for the storage of business equipment, tools, etc. On the other end of the scale, a debtor could own a factory or large office building with living quarters for the debtor as the debtor's principal resident. The legislative intent behind section 1322 (b) (2) was to provide stability in the long-term residential housing market. Therefore, the preferred status granted some creditors under this section was limited to holders of claims secured <u>only</u> by a security interest in the debtor's principal residence. No preferential treatment was given debts secured by property in addition to the debtor's principal residence. Such debts normally are incurred to make consumer purchases unrelated to the home, or to enable the debtor to engage in some form of business venture. In such circumstances the home is mortgaged not for its own sake, but for other purposes, and often is only one of several forms of security given. Congress granted no such protection for holders of these types of secured claims, presumably because any impact the bankruptcy laws might have upon them would not seriously affect the money market for home construction or purchase. Here, a substantial portion of a debtors' principal residence is devoted to the bed and breakfast operation. Indeed, the majority of the space in the structure is used for that purpose. The debtors are actually using the property as a bed and breakfast establishment for the purpose of generation income. The property clearly has inherent income producing power which the debtors are utilizing." [In re McVay 150 B.R. 254]. In another case the court allowed a modification of the debt secured by the debtor's principal residence because the purchase money mortgage also granted a security interest in fixtures, appurtenances, insurance proceeds and rents derived from the property in addition to the real estate.
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<u>WHAT IS A "CRAM DOWN"?</u>

Section 506 provides for a separation of an undersecured creditor's claim into two parts: secured to the extent of the value of the collateral, and unsecured for the balance of the claim. Here is an example of how a "cram down" works in a chapter 13. Assume a debtor owes $12,000 on a vehicle that has a value of only $8,000. The debtor could provide in the chapter 13 plan that the $8,000 be paid with interest. The remaining $4,000 would be paid as an unsecured debt with no interest and paid only what the debtor could afford. Once the debtor receives his discharge, the lien holder would be required to release the lien. However, if the collateral is a motor vehicle acquired for the personal use of the debtor, no cram down is allowed unless the debt was incurred more than 910 days before the bankruptcy was filed. If the debt was incurred for any other personal property, no cram down is allowed unless the debt was incurred over 1 year before the bankruptcy was filed.

What procedure should be used in valuing automobiles? In *Associates Commercial Corp. v. Rash,* 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), the Supreme Court held that in a cram down, the allowed amount of a claim secured by a debtor's automobile under 11 U.S.C. 506 (c) is the replacement value of the automobile. The Supreme Court explained that replacement value means the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition. The Supreme Court did not specify a method for determining replacement value, but rather left that to the bankruptcy court as the trier of fact. The debtor in In re Getz [242 B.R. 916] computed the value by using the average of the wholesale and retail values according to the National Automobile Dealers Association guidelines. The Court agreed with this procedure and stated in its opinion, "Our recognition that the replacement value standard, not the foreclosure value standard, governs in cram down cases and leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary. A creditor should not receive portions of its retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle, items such as warranties inventory storage, and reconditioning. Nor should the creditor gain from modifications to the property – e.g., the addition of accessories to a vehicle to which a creditor's lien would not extend under state law.

In the present case, the bankruptcy court determined that the best method for calculation the replacement value of an automobile was to use the average of the N.A.D.A. wholesale and retail values as a starting point, subject to appropriate adjustments according to other evidence of value introduced by the parties. The Panel notes that several bankruptcy courts have used this method of valuation since the Rash decision. Using the average of the N.A.D.A. wholesale and retail values as a starting point to determine the replacement value of a vehicle for a Chapter 13 cram down is consistent with the dictates of *Rash*, which recognized the discretion of the trial judge to adopt a rule for replacement valuation to serve the interests of predictability and uniformity. Further, the bankruptcy court's approach of using the average of retail and wholesale values merely as the starting point subject to adjustment by other evidence introduced by the parties is not precluded by *Rash's* rejection of the Seventh Circuit's approach of mechanically assigning the midpoint between the collateral's foreclosure and replacement values. The bankruptcy court's method of valuation did not include value for items not retained by the Debtor and also recognized that a debtor has access to markets other than the retail market."

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MAY A DEBTOR RETAIN NON – EXEMPT PROPERTY?

Section 1325 (a) (4) provides that the court shall confirm a plan if "the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 …". Therefore, if a debtor has, for example, $5,000, of non-exempt property which could be liquidated if a chapter 7 were filed, and if he has $40,000, of unsecured debt, he could keep the $5,000, of property if his chapter 13 provided for payments of at least $5,000, to the unsecured creditors.

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ARE CO–DEBTORS PROTECTED?

If a debtor files a chapter 7, he usually receives a discharge from unsecured debts such as credit card debt. If the debt is co–signed, the co–signer is not discharged from the debt. However, a co-debtor may be protected if the debtor files a chapter 13 and provides that the claim be paid in full under the plan. The creditor may obtain relief from the stay if it can be shown that the co-debtor received the consideration that is the basis of the claim or that such creditor's interest would be irreparably harmed by the continuation of such stay. The purpose of section 1301 is to allow a debtor the opportunity to repay the debt without permitting the creditor to bring undue pressure on the debtor by attempting to collect from the co-debtor.

May a chapter 13 debtor treat an unsecured co-signed debt differently from other unsecured debts? The answer to this question was 'Yes" in In re Campbell [242 B.R. 547]. The debtor in that case proposed to pay the unsecured co-debtor debt in full, together with post-petition interest, while paying the other unsecured creditors less than their claims. The chapter 13 trustee objected to confirmation of the plan. The court denied the objection and stated, "The trustee asserts that payment of interest on the Wachovia credit card debt is prejudicial to other unsecured creditors. Debtor's attorney argues that 11 U.S.C. 1301 allows preferential treatment for co-signed debts and permits the plan's treatment of the credit card debt. Post-petition interest on an unsecured co-signed note is a valid claim under 11 U.S.C. 101 of the Bankruptcy Code. Where a debtor has failed to account for post-petition interest in a Chapter 13 repayment plan and a co-debtor is obligated on the same debt, courts have lifted the automatic stay protecting co-debtors and allowed creditors to seek relief from the co-debtor party. They rely on the Code's legislative history which provides that a creditor is protected to the full amount of his claim including post-petition interest, costs and attorney's fees, if the contract so provides. Although post-petition interest is an element of a creditor's claim under the Code, 11 U.S.C. 502 (b) disallows payment of unmatured interest in ordinary bankruptcies and reorganizations. Section 502 (b) is not, however, a negation of the substantive rights of creditors. In instances where a debtor is solvent and capable of full repayment of creditors, the rule is excepted and interest is allowed. While under Section 502 (b), the claim for post-petition interest which the debtor seeks to pay in his plan is subject to disallowance, it remains part of the creditor's claim. If this claim is not paid, co-debtor relief is appropriate under 11 U.S.C. 1301 (c) (1). The only way to vindicate the Code's intent to fully protect co-debtors is to allow payment of post-petition interest. Otherwise, the Court must either permit co-debtor relief or stay the creditor action until the end of the case, with interest accruing as an obligation of the co-debtor for as long as five years. The first alternative eviscerates the intent of Section 1301 and the latter would involve an accounting burden to the creditor and a financial burden to the co-maker that it is not clear Congress intended.

Section 1322 (b) (1) if the Bankruptcy Code makes specific provisions for separately classifying unsecured debt. According to the statute, the plan may (1) designate a class or classes of unsecured claims. 11 U.S.C. 1322 (b) (1). The provision further allows different treatment of consumer debt where another individual is liable for such debt with the debtor. 11 U.S.C. 1322 (b) (1). This authorization of different treatment for unsecured co-debtor claims is interpreted as a liberalization of the Code's prior prohibition on dissimilar treatment of unsecured claims. Most courts construe the statutory language as allowing a debtor to repay co-debtor claims at a higher rate. It does not, conversely, authorize a debtor to repay such debts at a lower rate. In re Dornon [103 B.R. 61], held that the amendment sanctioned different and favored treatment for a debtor's consumer debts which are co-signed by another individual and constitutes a carve-out to the unfair discrimination standard. I hold that this authorization is broad enough to encompass interest on co-debtor obligations."

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CLAIMS – WHAT ARE THE DIFFERENT TYPES?

Claims filed in a bankruptcy may be classified into three categories – (1) unsecured, (2) secured, and (3) priority. Secured claims are those claims which are secured by some type of property, such as houses, cars, furniture, certificates of deposit, appliances, equipment, tools of trade, etc. Unsecured claims consist of those non-priority claims that have no security, i.e., credit cards, medical bills, etc. Priority claims are those claims identified in section 507. Included are (1) domestic support obligations, (2) administrative expenses, (3) wages not paid that were earned within 180 days before the bankruptcy was filed, (4) contributions to an employee benefit plan, (5) claims of persons engaged in the production or raising of grain, or fisherman, (6) claims of individuals, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individual, that were not delivered or provided, (7) federal income taxes, unless the criteria discussed above regarding dischargeability of taxes is satisfied, (8) sales taxes collected and not paid, and (9) property taxes if payable without penalty after one year before the bankruptcy was filed.

In a chapter 13 bankruptcy, secured claims must be paid or the property securing the debt must be surrendered. Unsecured claims must be paid based upon the debtor's financial ability. This may be 100% or 0% of the claim. Priority claims must be paid in full but without interest.

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WHAT KINDS OF DEBTS ARE NOT DISCHARGEABLE IN A CHAPTER 7?

Section 523 sets forth the types of debts that are excepted from discharge under a chapter 7. Included are the following:

(1) Taxes – the dischargeability of taxes is discussed above.

(2) Debts obtained by fraud, false pretenses, or false representation. There was one court ruling which held that although a debt which was obtained by fraud was non-dischargeable, attorney fees and finance charges relating to the debt were dischargeable. [In re Bonnifield 154 B.R. 743]. Another court held that a debt arising from an insufficient fund check was dischargeable. The creditor had argued that the issuance of the check was an implied representation that sufficient funds were in the account and that this constituted a false representation. The court stated, “a check is not a factual assertion at all, and therefore cannot be characterized as true or false. The check did not make any representation as to the state of debtor’s bank balance. As defined in the uniform commercial code, a check is simply a draft drawn on a bank and payable on demand, which contains an unconditional promise or order to pay a sum certain in money. Here the debtor’s belief that funds would become available was both honest and reasonable.” [In re Mahinske 155 B.R. 547].

(3) Debts owed to a single creditor for luxury goods or services, or for cash advances, incurred on or within 90 days prior to the bankruptcy filing.

(4) Cash advances that are extensions of consumer credit under an open-end credit plan obtained by an individual debtor on or within 70 days before the bankruptcy were filed. This includes balance transfer from one credit card to another.

(5) Debts not scheduled in time for the creditor to timely file a proof of claim. Courts have held that even if a creditor was not scheduled in a no-asset chapter 7, the debtor stills receives his discharge. The rationale is that the creditor, even it he had filed a proof of claim, would not have received any payment, and that since it is a no-asset case, no deadline for filing a timely proof of claim was ever set. Some courts have even denied debtors the right to reopen their chapter 7’s to add creditors contending the reopening the cases would serve no purpose and create needless administrative work. [In re Thibodeau 136 B.R. 7].

(6) Debts owed to a spouse, former spouse, or child, for alimony, maintenance, or support. This also includes any debts incurred by the debtor pursuant to a separation agreement or divorce decree, such as credit card debt.

(7) Debts resulting from the willful and malicious injury to the creditor.

(8) Debts for fines and penalties to a governmental entity.

(9) Debts for educational benefits (student loans) made by a governmental unit or a nonprofit institution. One court held that a credit union with a tax exempt status for federal income tax purposes, was not a nonprofit institution for bankruptcy purposes. The student loan debt was thus dischargeable. [In re Delmonis 169 B. R. 1]. Another court held that a credit union was a nonprofit institution since it was organized and existed as a nonprofit association with tax exempt status under the federal tax laws. [In re Roberts 149 B.R. 547]. Another court held that a loan from a commercial bank was non-dischargeable and stated in its opinion "Congress did not use language indicating that the loan itself must be by a non-profit institution, but that the program pursuant to which the loan was made be funded in part by a non-profit institution. Nothing in the legislative history surrounding this section evidences an intent to limit it solely to the funding of the loan itself. The plain language of the section 523) (a) (8) indicates that it is the program that needs to be funded by a non-profit institution." [In re Pilcher 149 B.R. 595].

If the debtor can show payment of the debt would impose an undue hardship on him or his dependents, the court may allow the debt to be discharged. This undue hardship is difficult to prove. A debtor whose is disabled and can show that his earning capacity is forever limited is an example of this hardship. A temporary disability or a run of hard luck is usually not enough to have the debt discharged. One court, in denying a debtor an undue hardship discharge, set out the following tests to evaluate "undue hardship"; (a) total incapacity now and in the future to pay one's debts for reasons not within the control of the debtor; (b) whether the debtor has made a good faith effort to negotiate a deferment or forebearance of payment; (c) whether the hardship will be long-term; (d) whether the debtor has made payments on the student loan; (e) whether there is permanent or long-term disability of the debtor; (f) the ability of the debtor to obtain gainful employment in the area of study; (g) whether the debtor has made a good faith effort to maximize income and minimize expenses; (h) whether the dominant purpose of the bankruptcy petition was to discharge the student loans, with discharge being denied if such was the dominant purpose of the bankruptcy; and (i) the ratio of the student loan to the total indebtedness with a larger ratio resulting in denial of the discharge. [In re Ford 151 B.R. 135]. May a court 'split' the debt? In re Campbell [242 B.R. 327] addresses this question and allowed a partial discharge in the amount of $6,000 of a student loan debt that totaled $16,000. In its opinion the court said, "Several courts have addressed the issue of whether discharge under section 523 (a) (8) (B) is an all or nothing proposition. Some courts have held that the total educational debt is either dischargeable or non-dischargeable. Other courts have recognized a Bankruptcy Court's equitable power to discharge a portion of the debt, while leaving the remaining amount non-dischargeable. The Court agrees with the latter cases which recognize a Bankruptcy Court's ability to order a partial discharge of a student loan under certain circumstances. The partial dischargeability or other modification of a student loan debt accomplishes Congress' purpose of providing debtors with a fresh start while maximizing the repayment of the debt. The Court agrees that allowing partial discharge of student loans is the more equitable approach; treating student loan dischargeability as an all or nothing proposition would yield absurd results in certain circumstances. Thus, the Court can, at its discretion, excuse any portion of the Plaintiff's student loan obligation which would create an undue hardship, and can recommend a payment plan which will lead to the reduced obligation being paid in full."

(10) Debts incurred due to the death or injury caused by the debtor's unlawful operation of a vehicle due to the use of alcohol, drugs, or another substance.

[TOP]

MAY STUDENT LOANS BE CLASSIFIED AS A SEPARATE CLASS OF CREDITOR? MAYBE.

As discussed above, student loans are considered a non-dischargeable debt. A chapter 13 debtor filed a plan providing for his student loan to be paid back 100% concurrently with secured creditors. The plan also provided for a 100% dividend to unsecured creditors to be paid after the student loan and secured creditors were paid. The trustee filed an objection to confirmation of the plan contending the concurrent payment constituted unfair discrimination in the classification and treatment of unsecured creditors under section 1322 (b) (1). The court held for the debtor and set out four considerations to determine if unfair discrimination was present: (1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without such discrimination; (3) whether such classification was proposed in good faith; and (4) the treatment of the class discriminated against. The court held that the classification did not discriminate unfairly because, (1) the plan provided for a 100% payment of all unsecured claims, (2) the student loan obligation was non-dischargeable, and (3) the debtor had the right under section 1322 (b) (4) to provide for payments on any unsecured claim to be made concurrently with payments on any secured claim. [In the matter of Foreman 136 B.R. 532].

[TOP]

STUDENT LOAN INTEREST – DOES IT CONTINUE TO ACCRUE DURING THE PENDENCY OF A CHAPTER 13? – YES!

In re Girard [243 B.R. 894] dealt with this question and held in favor of the creditor. The debtors had completed their Chapter 13 plan and had received their discharge. The student loan creditor's claim had been paid in full through the plan. The claim was for the principal amount of the loan plus pre-petition interest. Subsequent to the discharge the creditor sought to collect the interest that had accrued on the student loan debt while the Chapter 13 was pending. The debtors argued that the interest should not accrue. The Court held for the creditor and stated in its opinion, "Student loans are nondischargeable. 11 U.S.C. 523 (a) (8). The Bankruptcy Code fails to mention whether or not interest continues to accrue on the nondischargeable student loan during the pendency of the Chapter 13 plan. However, since the underlying debt is nondischargeable, so is the interest and debtor must pay the interest after discharge. Even if a student loan debt is modified by a Chapter 13 plan, the unpaid portion of the student loan debt survives bankruptcy. Creditors may still recover the unpaid portion of the student loan personally from the debtor outside of bankruptcy. Here, the unpaid portion is post-petition interest and interest which has accrued since the Chapter 13 discharge. Postpetition interest is nondischargeable and the debtors remain liable for that interest subsequent to the bankruptcy proceedings."

[TOP]

HOW FREQUENTLY MAY ONE RECEIVE A DISCHARGE UNDER CHAPTER 7?

Section 727 (a) (8) provides that a debtor may not receive a discharge under chapter 7 if a discharge had been granted under a previous chapter 7 commenced within eight years before the date of filing the present chapter 7.

Section 727 (a) (9) prohibits a debtor from receiving a chapter 7 discharge if, within six years before the date of filing the present chapter 7, the debtor had received a discharge from a chapter 13, unless the unsecured claims were paid at least 70% of their claims through the chapter 13.

It should be noted that only an individual may receive a chapter 7 discharge. [Section 727 (a) (1)]. A corporation may not receive a discharge under chapter 7.

[TOP]

MUST A CHAPTER 7 DEBTOR EITHER REDEEM, REAFFIRM, OR SURRENDER COLLATERAL? – YES

Section 521 (6) requires that in a case under chapter 7, not retain possession of personal property as to which a creditor has an allowed claim for the purchase price secured by an interest in such property unless the debtor, reaffirms the debt, redeems the debt, or surrender the property.

[TOP]

MAY A DEBTOR BE DISCRIMINATED AGAINST BECAUSE HE FILED A BANKRUPTCY? – NO!

Section 525 specifically prohibits discrimination against a debtor merely because he filed a bankruptcy. This includes discrimination by any governmental unit in the licensing procedure, such as attorneys, real estate brokers, doctors, barbers, plumbers, etc. This section has also been interpreted to prevent discrimination by any employer, public or private, in the employment of a bankrupt debtor. This section applies only to discrimination based solely on the basis of the bankruptcy. It does not prohibit consideration of other factors, such as future financial responsibility or ability. This section has also been used to require a governmental unit to rescind the suspension of a drivers' license. In re Brown [244 B.R. 62] is a case where the Chapter 13 debtor provided that traffic fines be paid in full through his Chapter 13. The debtor asked the Bankruptcy Court to order the governmental unit that had suspended his license, because of the unpaid fines, to rescind the suspension. The municipal court argued that the license should not be reinstated until the fines are paid through the Chapter 13 plan. The Court held in favor of the debtor and stated, "The authority to direct the municipal court to rescind a driver license suspension based on failure to pay a fine, which fine is proposed to be paid through a debtor's Chapter 13 plan, is found in 11 U.S.C. 525 (a), which provides in pertinent part that 'a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title, or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act'. Most courts have concluded that the language of Section 525 could not be more specific in prohibiting a governmental unit from denying or refusing to renew a driver's license solely because such bankrupt or debtor is or has been a debtor or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act. It follows inexorably that Section 525 applies in this case, and that suspension of the debtor's license solely because of failure to pay surcharges, or because of a delay in payment occasioned by the Chapter 13 plan, violates Section 525. I conclude that where, as here, a Chapter 13 debtor is paying an otherwise dischargeable debt through a Chapter 13 plan, section 525 of the Bankruptcy Code prohibits a municipal court from refusing to renew the debtor's license, and authorizes the bankruptcy court to direct the municipal court to rescind its suspension of the debtor's driving privileges." (Dischargeability of the fines was not discussed in this case).

[TOP]

MAY A BANKRUPTCY TRUSTEE RECOVER A DEBTOR'S CONTRIBUTION TO HIS CHURCH? – MAYBE.

Section 548 deals with what is referred to as "fraudulent transfers and obligations". It provides that a trustee may avoid a charitable contribution made by a debtor within one year before the bankruptcy filing unless the debtor can show, (1) the contribution did not exceed 15% of the debtor's gross income for the year in which the contribution was made, or (2) if the contribution exceeded the 15%, it was consistent with the practices of the debtor in making charitable contributions. An excellent discussion of this issue is provided in the case, In re Young 148 B.R. 886.

[TOP]

UTILITY COMPANIES – MUST THEY PROVIDE SERVICE TO A BANKRUPT DEBTORS? – YES!

Section 366 prohibits a utility company from refusing service to a bankrupt debtor whose account is past due. The utility may not disconnect service, and if disconnected prior to the bankruptcy filing the utility must reconnect the service. However, the utility may require adequate assurance of payment, which is defined as a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption, or another form of security that is mutually agreed on between the utility and the debtor or the trustee.

[TOP]

LESSON 4: A BANKRUPT'S OPTIONS

CONVERSION OR DISMISSAL OF CHAPTER 7

Section 706 (a) reads as follows: "The debtor may convert a case under this chapter to a case under 11, 12, or 13 of this title at any time, … Any waiver of the right to convert a case under this subsection is unenforceable." Does this mean a debtor has the absolute right to convert a chapter 7 to a chapter 13? Courts differ in their answer to this question. In re Dews [243 B.R. 337] the court held the debtor had no absolute right to convert and stated in its opinion, "There is a split in authority on the issue whether this provision creates an absolute, one-time right to convert a chapter 7 case to chapter 13. Some courts literally interpret the statutory language and legislative history to mandate, that without regard to the actions and/or motivations of the debtors, and absent extreme circumstances, cases must be converted upon debtors' requests. On the other hand, some courts decline to take the literal approach, and examine the motivation of debtors, including whether they are acting in good faith. This Court declines to follow the line of cases that take the literal approach. While respecting their rationale, they fail to recognize that in the context of an inherently equitable remedy, there may be instances where the requests of debtors should not be honored. First, courts should make some determination regarding the motives of the debtors; i.e., are they honestly trying to pursue a plan of repayment to creditors while retaining essential assets such as homes and automobiles, or are they using the system simply to forestall collection efforts, without any real hope of repayment. Second, courts should make a preliminary inquiry as to the quality of any proposed chapter 13 plan, and whether it would meet confirmation requirements. It is this Court's view that it is a waste of the parties' and court's resources to simply convert cases to chapter 13 where there is a high likelihood that the plans cannot be confirmed."

However, the court is prohibited from converting the chapter 7 to a chapter 13 without the debtors consent since that would, in effect, put the debtor in a mandatory chapter 13. A debtor cannot be forced to be in a chapter 13.

Section 707 gives the court authority to dismiss a chapter 7, but does not give the debtor the same right. Thus, a chapter 7 debtor who changes his mind, may be prevented from dismissing his case if the court feels that the best interest of creditors will be served by continuing the chapter 7. May a chapter 7 be dismissed based upon a debtor's lack of good faith? The court discussed this question in In re Etcheverry [242 B.R. 503] and held that bad faith is not a ground for dismissal for cause under section 707 (a). The court stated in its opinion, "…the Bankruptcy Code must be construed liberally in favor of the debtor and strictly against the creditor. As a preliminary matter, it is important to note that commentators have questioned the ability of a bankruptcy court to dismiss a Chapter 7 case for lack of good faith. While the Bankruptcy Code explicitly imposes a good faith requirement in the proposal of Chapter 11, 12, and 13 plans, no such mandate is articulated under Chapter 7. Section 707 (a) of the Bankruptcy Code provides that a bankruptcy court 'may dismiss a case under this chapter only after notice and hearing and only for cause, including – (1) unreasonable delay by the debtor that is prejudicial to creditors; (2) nonpayment of any fees or charges required under chapter 123 of title 28;

and, (3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee. I find that Congress deliberately omitted the good faith requirement from chapter 7 of the Bankruptcy Code. In 2005 Congress enacted a new Bankruptcy Code. The Code did not contain any express requirement that bankruptcy petitions be filed in good faith. It, however, did retain the concept that where a debtor chooses to maintain its relationship with its creditors in an attempt to reorganize, the debtor must demonstrate good faith in that relationship. See U.S.C. sections 1129 (a) (3), 1225 (a) (3), and 1325 (a) (3). The foregoing provisions contain identical language mandating that the court, prior to confirming a Chapter 11, 12 or 13 plan must find that the reorganization proposal has been made in good faith. I find that the absence of this language in the Bankruptcy Code's liquidation chapter, Chapter 7, means that Congress did not incorporate a good faith requirement when a bankruptcy court rules on motions to dismiss under 11 U.S.C. 707 (a). The exclusion of good faith language in 11 U.S.C. 707 (a) makes sense if one examines the relationship of the debtor and creditor in a liquidation case. When a debtor liquidates, it surrenders all of its nonexempt assets for distribution among its creditors, and the debtor-creditor relationship is presumably terminated. Since liquidation requires no ongoing relationship between the debtor and creditor, the ability to discharge should be made available to any debtor that is willing to risk the chance that some of its debts may not be discharged."

Means Test- Abuse – the court may dismiss a chapter 7 if it finds that granting the relief would constitute abuse of the bankruptcy process. The means test compares the medium income of the debtor with the medium income of a family the same size in the same location in the country. If the medium income exceeds the standard another computation must be performed. This second computation considers IRS guidelines for living expenses, transportation and medical expenses, health, term life, and disability insurance premiums, debt on secured debt, income taxes, child care, contribution, etc. This abuse has been considered to include cases where the court finds that the debtor has the ability to pay back at least some amount to his unsecured creditors. Although the court cannot require the debtor to convert to a chapter 13, the debtor may feel forced to convert when faced with the possibility of dismissal of the chapter 7.

Courts have held that the conversion of a chapter 7 to a chapter 13 did not reimpose the automatic stay that had been lifted in the debtor's chapter 7. [In re Parker 154 B.R. 240].

Beware – if a priority tax debt to IRS has been paid in full without interest in a chapter 13, and the bankruptcy is converted to a chapter 7, the IRS debt for interest on the priority tax is not discharged in the chapter 7. It would have been discharged if the debtor had remained in the chapter 13 and received a discharge.

[TOP]

CONVERSION OR DISMISSAL OF CHAPTER 13

Section 1307 states that a debtor has the absolute right to convert his chapter 13 to a chapter 7. However, the court could dismiss the chapter 7 under the provisions of section 707, which includes abuse, as discussed above.

The debtor is also given the absolute right to dismiss his chapter 13 unless the case was converted from a chapter 7, 11 or 12. If the debtor was allowed to file a chapter 7, convert to a chapter 13, and then dismiss the case, that would allow a circumvention of section 707 which denies the absolute right to a debtor to dismiss a chapter 7.

The court, of course, can dismiss a chapter 13 for various reasons, including failure to make payments to the trustee, failure to file a plan, failure to file tax returns or pay post petition taxes, etc.

[TOP]

WHAT IS THE SUPER DISCHARGE OF CHAPTER 13?

As discussed above, section 523 lists several types of debts that are not discharged in a chapter 7 bankruptcy. However, the chapter 13 discharge is much more liberal. Section 1328 (a) excepts only a few debts from the chapter 13 discharge. They are debts relating to (1) support and alimony, (2) student loans, (3) death or injury because the debtor was operation a vehicle unlawfully due to intoxication, (4) restitution or a criminal fine, and (5) post petition obligations of the debtor. Therefore, debts such as those incurred through fraud or arising from willful and malicious injury by the debtor would be discharged in the chapter 13.

In one case the court granted a chapter 13 discharge before all of the plan payments were made. The confirmed plan provided for a 10% dividend to be paid to the unsecured creditors. The plan payments were $282.00, per month for a 43 month period. The total amount of unsecured claims timely filed by unsecured creditors was well below the amount of unsecured debt in the debtor's schedules. As a result, it took only 37 months to pay the 10% dividend to the unsecured creditors. The trustee argued that the debtor should continue making payments until the 43 month period had lapsed. The debtor asked the court to grant him the discharge contending the plan had been completed as confirmed since the creditors had received the 10% dividend. The court held for the debtor and acknowledge that the bankruptcy code offered no clue as to how this issue should be decided, and stated in its opinion, "Assume that the debtor proposed to pay unsecured creditors 100% in 43 months, but due to the failure of some scheduled creditors to timely file proofs of claim, the debtor is able to provide the trustee with enough money to pay 100% to unsecured creditors in 37 months. It is inconceivable that the debtor could be made to continue payments for six more months to pay unsecured creditors more than 100% of their claims. On the other hand, suppose the debtor gets a 100% 43-month plan confirmed, but allowed unsecured creditor claims exceed the amount of unsecured debt scheduled by the debtor. Suppose further that the debtor pays the trustee the payments required by the order of confirmation religiously for 43 months, but due to the higher than expected amount of unsecured claim, those payments are only enough to pay unsecured creditors an 85% dividend. Clearly the debtor has not completed her payments under the plan. The conclusion these examples lead to is that the duration of the plan can be changed, either formally by plan amendment or informally by completing payments sufficient to pay the required percentage early because of reduction in the allowed unsecured claims as compared with scheduled debt. The fact that the plan called for 43 monthly payments is irrelevant. The debtor has made all payments required of him by his chapter 13 plan to the trustee." [In re Phelps 149 B.R. 534].

[TOP]

WHAT IS THE HARDSHIP DISCHARGE OF CHAPTER 13?

Section 1328 (b) provides what is referred to as the "hardship discharge". This section allows a chapter 13 debtor to obtain a chapter 13-discharge even thought he has not made all of the payments required by his confirmed plan. To receive the hardship discharge, the debtor must show the court that his inability to make the payments as required under the plan is due to circumstances for which the debtor should not be held accountable. The debtor must also show that the unsecured creditors have received at least as much in payments that they would have received if the debtor had filed a chapter 7. A final requirement is to show that a modification of the plan is not practicable.

The debtor cannot obtain the benefits of a chapter 13 "super discharge" with a "hardship discharge". The exceptions to a discharge received under section 1328 (b), are the same exceptions as those provided for a chapter 7 discharge.

[TOP]

MAY A CHAPTER 13 PLAN BE MODIFIED? – YES.

Section 1329 provides that the debtor, the trustee, or an unsecured creditor may request a modification of the terms of a confirmed plan. Most modifications are initiated by the debtor to reduce the plan payments because of a change in the debtor's financial condition. However, it is not uncommon for the chapter 13 trustee to monitor the debtor's income, and if he feels the debtor could increase the amount paid to unsecured creditors, request the court to modify the plan.

In Barbosa v. Solomon, [243 B.R. 562] the Chapter 13 Trustee filed a motion to modify the Debtor's plan to require the Debtors to pay into the plan the proceeds from the post petition sale of real estate that had increased in value substantially since the Chapter 13 bankruptcy was filed. The result would be to increase the dividend to unsecured creditors form 10% to 100%. The Debtor's argued that the creditors were bound by the confirmed Chapter 13 plan and that they should be allowed to keep the proceeds. The court held for the Trustee and stated in its opinion, "The backdrop for the Court's decision is the recognition that a confirmed plan is a contract binding on creditors and that the discharge of debts is a privilege, not a right. Overriding all other concerns is the issue of good faith. In view of congress's intent in enacting chapter 13 to encourage debtors to repay their debts to the best of their ability, it would be anomalous for this Court to determine that the Debtors can retain the excess proceeds from the sale of the property without satisfying their unsecured claims. If the Debtors modify their plan to provide for full payment of unsecured claims, there is no question that the best interest test of Section 1325 (a) (4) would be satisfied. If they modify their plan to reduce the time for paying unsecured creditors, without using the sale proceeds attributable to the appreciation in value of their Property to pay more that a 10% dividend to unsecured creditors, the Court finds that the best interest test of section 1325 (a) (4) would not be satisfied, and, moreover, their modified plan would not be proposed in good faith. In other words, the Debtors would be engaged in a bad faith manipulation of the Bankruptcy Code, if they insist on retaining the excess sale proceeds and obtaining the broad discharge afforded by Section 1328 (a)."

The debtor in In re Taylor [243 B.R. 226] filed a motion to modify his confirmed chapter 13 plan, after surrendering an automobile that secured the creditor's claim. He requested the court to reclassify the remaining obligation to the creditor from a secured claim to an unsecured claim. The creditor objected contending that since the debtor had been using the vehicle for two years post-confirmation, he cannot now change his mind since the vehicle had depreciated in value. The court held for the creditor and stated in its opinion, "Clearly, a debtor ought not to be given a two, three, four or five year 'window' to exercise a unilateral option of 'surrender' while he runs a vehicle 'into the ground'. No provision of the Code, and no provision that could be reasonably implied by the Plans and Orders of the Confirmation used in this District, could support such a result. This is not simply a matter of reason and good sense, nor is it compelled by the analysis used in cases in which it is said the 'reclassification' is not one of the permitted 'modifications' contemplated by 11 U.S.C. 1329. Rather, it is this writer's view that the 'good faith' requirement of 11 U.S.C. 1325 (a) (3), which is incorporated into the requirements for modification by 11 U.S.C. 1329 (b) (1), is a prerequisite to anything a chapter 13 debtor wishes to change after confirmation under section 1329 or under any ‘implied provision’ of the Plan. And one must look at ‘good faith’ on a case by case basis, always. It is often also said that a debtor should be permitted to do such things in chapter 13 as the debtor here wishes to do, so long as creditors are being treated at least as well as they should be in chapter 7. This argument too often overlooks, and perhaps even demeans, the fact that chapter 13 is thought to be a commendable alternative because it is not a chapter 7 case in disguise. Not just the chapter 7 test must be met, but also the test of ‘good faith’ and the commitment of ‘projected disposable income’. If creditors must fare worse in a particular chapter 13 case because a debtor converts to chapter 7 in order to sidestep the ‘good faith’ requirement that prevented his intended ends in chapter 13, then the institution of chapter 13 as a program may be better served thereby, and many of those same creditors will fare better in cases that follow.

On the other hand, there is much to be said for encouraging an effort to succeed in chapter 13, as opposed to an initial choice of chapter 7. It is by assessing the ‘good faith’ of the debtor that we assure that attempting rehabilitation instead of liquidating will not always be a win-win choice even for the debtor who seeks further advantage (without converting to chapter 7) that amounts to a victimization of a creditor who did not interfere with the debtor’s effort to perform the debtor’s own proposal for redeeming the collateral from the lien.

All of this commands, in my view, that there be no general rule to be universally applied in cases in which the decision to look to the collateral itself is sought to be compelled by the debtor rather than freely chosen by the lender. Some of what happens to cars (or computers, or tools of the trade, or other property that a chapter 13 debtor might retain subject to a pre-petition security interest) is fully known and understood by a lender to be as much the lender’s risk as the borrower’s, such as the risk of mechanical breakdown too expensive to repair.

And just as debtors might be found to be knowingly attempting to victimize a lender through the chapter 13 process, a general rule in favor of lenders in every situation in which the lender claims it doesn’t want the collateral back may itself be used by creditors, in bad faith, to try to trap debtors who have acted in all good faith. So the question is a matter for case-by-case determination, based on whether the debtor is found to be acting in good faith under the circumstances and based on how the goal of fundamental fairness is to be served not only in such cases, but by the chapter 13 program. Every post-confirmation instance of the debtor seeking to force the lender to take the collateral while the lender says it doesn’t want it must be examined to see if the blame for the loss of value that is behind the creditor’s decision is to be placed on the debtor, or whether, on the other hand, the risk was one accepted by the lienor regardless of whether the borrower is or is not a chapter 13 debtor.”

[TOP]

MAY A DEBTOR VOID A LIEN ON PROPERTY? – YES.

Section 522 (f) (1) (b) allows a debtor to avoid nonpossessory, nonpurchase-money security interest in exempt personal property such as furniture, appliances, tools of trade, etc. This section is particularly beneficial to the many debtors who have secured loans from loan companies with household goods. The lien may not be avoided if it is a purchase money lien. Does the refinancing of a debt transform a purchase-money security interest into a non-purchase money security interest? Some courts have held that it does, but the majority rule it does not. [In re Clark 156 B.R. 693]. The rationale is that to allow the transformation would discourage creditors holding purchase money security interests from helping the debtors work out their problems through a refinancing.

To void the lien the debtor must file a motion with the court. However the bankruptcy code and rules are silent as to whether the debtor must file the motion within a given period of time. This issue was brought before the court when a debtor filed the motion after the discharge was granted. The creditor argued that the motion should have been filed before the discharge. The court disagreed and said " In light of the fact that neither the bankruptcy code or rules provide any particular time constraints for raising lien avoidance, the majority of jurisdictions hold that there is no time limit absent prejudice or fraud to creditors and given that the creditors in the instant case have not shown or even posited that the debtor's motion for lien avoidance is fraudulent or has a prejudicial impact on their interests, the court finds that the creditors are not prejudiced by the debtor's motion for lien avoidance." [In re Jacobs 154 B.R. 359].

[TOP]

WHAT IS A CHAPTER 20?

'Chapter 20' is the colloquial term used to describe the filing of a chapter 13 shortly after the filing of a chapter 7 case. There is no prohibition against this tactic but the courts are very critically of this procedure. By using the two chapters in combination, a debtor can gain the advantages of each chapter while accepting the burdens of neither. The courts question whether or not this multiple filing is in conflict with section 1325 (a) (3), which requires a chapter 13 plan to be filed in good faith. Some courts require the debtor to list in his chapter 13 all of the creditors for which a discharge was received in the chapter 7, though technically they are no longer creditors since the debts had been discharged. In re Sunderland [157 B.R. 39] the debtor filed a chapter 13 only four months after receiving a discharge from $24,000 of unsecured debts in a chapter 7. The court denied confirmation of the chapter 13 plan and stated in its opinion, "This case presents more clearly than most a developing trend toward serial bankruptcies. The serial cases do not reflect the recognized right to liquidation if a reorganization fails. Rather, these cases exemplify the reverse of that right. The debtor first files a liquidation proceeding and discharges all or most of his unsecured obligations, and then files a reorganization to deal with whatever remains. There is no objection to this process by unsecured creditors because such creditors are not listed on the schedules in the second case and are not even aware that other creditors are proposed to be paid. There is no specific prohibition in the bankruptcy code against such practice, but there is also no endorsement of it. Its compliance with the spirit of chapter 13 is questionable. This court believes that any debtor who proposes a chapter 13 plan soon after a chapter 7 filing must be prepared to meet all tests for confirmation in chapter 13 on a heightened scrutiny basis as employed generally in this district for plans which propose nominal repayment to general unsecured creditors. Absent a marked change in circumstances, the scrutiny level will increase as the interval between the two cases decreases. Additionally, if the filing dates for the two cases are within a twelve-month period, this court will require an opportunity for objection for all unsecured creditors whose claims were discharged in the initial chapter 7 case. Further, those parties must be told specifically that no repayment is proposed for them."

In re Keach [243 B.R. 851] is an excellent example reflecting what some courts consider in dealing with chapter 20's. The debtor, Keach, first filed a Chapter 7. One claim was held to be nondischargeable because of fraud. After receiving his Chapter 7 discharge, the debtor filed a Chapter 13 while his Chapter 7 was still open. The Chapter 13 plan proposed to pay only a 5% dividend on the fraud claim which would result in a discharge of 95% of the claim under the super discharge provisions of Chapter 13. The Chapter 13 trustee and the creditor objected to the plan contending it was filed in bad faith as that term is used in Section 1325 (a) (3). The Bankruptcy Court denied confirmation and the debtor appealed. The appellate Court held in favor of the debtor and stated, "The meaning of good faith is simple honesty of purpose. This is the phrase's common English meaning. It is also how the phrase is used in commercial law. Section 1328 expressly grants a debtor a discharge even if the debts result from conduct such as fraud and hence are nondischargeable in Chapter 7. Section 1325 expressly requires a debtor only to devote all projected three year disposable income to the plan and provide creditors with at least what they would get in Chapter 7. And the Code contains no prohibition against the debtor filing a Chapter 13 petition after a Chapter 7 case, not even a prohibition against filing while the Chapter 7 case remains open.

One might disagree with the policy choices made by Congress in permitting a broad discharge under Chapter 13, or in placing only limited restrictions on successive filings. But those choices having been made and clearly expressed, courts are bound to enforce them. Any contrary interpretation would establish nonstatutory eligibility requirements for Chapter 13.

The Code contains no mandate against such a second filing. There is no indication in the record, moreover, that at the time of the Chapter 13 filing, property claimed as property of the Chapter 13 estate was still property of the Chapter 7 estate. And, as we have seen, many courts permit such a filing if it is made after the discharge enters in the prior case, which is our situation.

The Debtor here did have a change in circumstances. In fact, he had two changes of circumstances between the first and the second filing. Kuzniar (the creditor) was about to have the sheriff sell the Debtor's home. And the Kuzniar debt had been declared nondischargeable under section 523 (a) (2) (A). There is therefore no lack of good faith because of this second filing even under an expansive view of good faith. Moreover, the Debtor did his best to avoid the second filing by attempting to convert the Chapter 7 case to Chapter 13. His second filing is thus quite different from the situation where a debtor files a second time in order to obtain reimposition of the automatic stay after having unsuccesfully opposed a lifting of the stay in the prior case.

It was also error for the bankruptcy judge here to see bad faith in the Debtor's Chapter 13 plan because it promised creditors less than what the bankruptcy judge thought they deserved on account of the Debtor's prefiling conduct. In Section 1325, Congress set the minimum dividend by employing the disposable income and the best interests tests. Congress having spoken, no judge may raise the bar.

And it was error for the bankruptcy judge to treat as an indicator of bad faith the proposed discharge of debt which was nondischageable in the Debtor's Chapter 7 case. Congress has spoken clearly in Section 1328 by providing for the discharge of debt, deemed not dischargeable in Chapter 7. No judge may override Congress's decision to do so, regardless of the judge's distaste in participation in the discharge of a debt immorally incurred. Right and wrong are the province of judges, but only within the parameters set by the legislative branch."

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LESSON 5: CONCLUSION

Bankruptcy impacts many individuals. It also impacts many areas of law in one way or another. Attorneys involved in criminal law, family law, real estate law, probate law, collections, creditor's rights, labor law, and many other areas of law are finding themselves confronted with bankruptcy law issues. To best serve their clients they must continually keep abreast of the current bankruptcy law and its changes.

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