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Douglas Q. Wickham

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# CHAPTER 7 OR CHAPTER 13: GUIDING CONSUMER DEBTOR CHOICE UNDER THE BANKRUPTCY REFORM ACT

DOUGLAS Q. WICKHAM†

In the debate over bankruptcy reform during the 1970s some critics urged that a counseling service for consumer debtors be engrafted onto the process.[1] It was more or less assumed that attorneys and judges could not or would not provide what was viewed as a necessary social service. Congress, however, chose not to change the essentially remedial nature of the bankruptcy statutes. It cannot be the function of statutory remedies to infuse into debtors better judgment than they had before, nor can they ordinarily alter the fortunes of individuals or businesses. A growing number of both public and private agencies, however, are attempting to educate and counsel the participants in our consumer credit society.[2] Sometimes they experience success in the informal adjustment of an individual's debts. Meanwhile, the remedies legislated by Congress remain available to provide relief when informal adjustment fails.

It is the responsibility of the practicing bar to provide *informed* access to these statutory remedies and to execute each remedial proceeding to the client's *maximum* advantage. Debtor relief has traditionally been considered a mystery and a specialty within the profession, but the problems of insolvent consumer debtors can and should be treated as an accepted facet of general practice. Debtor clients must be guided to an informed decision about whether to seek statutory relief and how to choose between Chapters 7[3] and 13[4] of the Bankruptcy Reform Act of 1978. Though the Reform Act has undoubtedly altered the choices that certain clients would make, the ana-

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† Professor of Law, University of Tennessee College of Law. B.A. 1963, LL.B. 1966, Yale University; LL.M. 1971, Harvard University.

1. Girth, *The Bankruptcy Reform Process: Maximizing Judicial Control in Wage Earners' Plans*, 11 U. MICH. J.L. REF. 51, 68-69 (1977).

2. A. COHEN, DEBTOR-CREDITOR RELATIONS UNDER THE BANKRUPTCY ACT OF 1978 (1979) 189-216, provides an excellent introduction to the range of debt counseling services and state regulation of them.

3. 11 U.S.C.A. §§ 701-766 (West 1979).

4. *Id.* §§ 1301-1330.

lytic process confronting the attorney remains the same.[5] The attorney must determine the appropriate remedy, properly prepare the case, support the client during the proceeding, and counsel the client about post-proceeding creditors' rights and debtor remedies.

## I. Guiding the Client's Choice

### A. *Straight Bankruptcy*

Chapter 7 bankruptcy, with its discharge of unsatisfied debt, can provide the most immediate and drastic relief for an insolvent consumer debtor. No course of action can be chosen intelligently without calculating the probable dollar value of this remedy for each client. There are major improvements in the effectiveness of a bankruptcy discharge under the Reform Act,[6] but the basic remedial formula is simply stated and remains the same: the debtor gives up all nonexempt property for liquidation and distribution to creditors in return for a discharge of all scheduled, dischargeable debts. A discharge occasionally is denied, however, and even when granted does not eliminate automatically the rights of every creditor.[7] The impact of this formula on the individual client, therefore, must be analyzed and compared with alternatives before a client can make an informed choice among available courses of conduct.

#### 1. Property Given Up

One of the important changes for consumer debtors under the Reform Act is the creation of federal bankruptcy exemptions.[8] One who is not judgment proof under a given state's exemption laws may effectively be so in a bankruptcy proceeding.[9] With the possible exception of the $7,500 homestead equity, the dollar values provided in Reform Act exemptions are likely to cover all the property owned by most low and moderate income families who are forced to seek statutory relief. Prior contractual waivers of exemption are specifically made unen-

5. *See* Wickham, *Bankruptcy or Not? Advice for Attorneys Who Counsel Consumer Debtors*, 41 TENN. L. REV. 667 (1974).

6. *See* Rendleman, *The Bankruptcy Discharge: Toward A Fresher Start*, this Symposium.

7. *See* text accompanying notes 16-33 *infra*.

8. 11 U.S.C.A. § 522 (West 1979); *see* Vukowich, *Debtor's Exemption Rights Under the Bankruptcy Reform Act*, this Symposium.

9. Any state exemption package less than $7900 is automatically less than the absolute minimum available in bankruptcy. *See* 11 U.S.C.A. § 522(d)(5) (West 1979).

forceable.[10] Further relief is provided because nonpurchase money liens on exempt items retained for personal use can be avoided in a bankruptcy proceeding.[11] Debtors are given the option of taking their state exemption package if it is more advantageous.[12] Perhaps the best evidence of the relative generosity of this Reform Act exemption package is that some states have passed statutes specifically denying their domiciliaries its benefit.[13]

The more comprehensive definition of estate property under the Reform Act has eliminated some prior situations in which tort claims were not considered part of the bankrupt's estate.[14] Now all existing causes of action are estate property subject to liquidation. From the debtor's point of view the only surprise losses of property would be property included in the estate under the windfall clauses,[15] and thus, in calculating the potential remedial effect of Chapter 7 relief, the attorney should be aware of dying relatives or pending divorce settlements.

## 2. Discharge

### *a. Availability*

Only a few of the general bars to discharge[16] are of potential significance to the consumer debtor. The six-year bar of a prior bankruptcy discharge ordinarily will be the major eligibility barrier. The Reform Act has made one significant change in this area of discharge availability. As before, completion of a Chapter 13 extension plan in which all creditors are paid in full does not raise the time bar,[17] but

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10. *Id.* § 522(e).

11. *Id.* § 522(f).

12. *Id.* § 522(b).

13. H.R. 2305, 34th Leg., 2d Reg. Sess., ch. 59, § 1, 1980 Ariz. Legis. Serv. No. 3, at 132 (amending ARIZ. REV. STAT. ANN. § 33-1133 (West Cum. Supp. 198); FLA. STAT. ANN. § 222.20 (West Cum. Supp. 1979); LA. REV. STAT. ANN. § 13:3881(B) (West Cum. Supp. 1980); OHIO REV. CODE ANN. § 2329.66.2 (Page Cum. Supp. 1979); VA. CODE § 34-3.1 (Cum. Supp. 1979). The Ohio exemption statute, however, roughly parallels the new federal exemptions. *Compare* OHIO REV. STAT. ANN. § 2329.66 (Page Cum. Supp. 1979) *with* 11 U.S.C.A. § 522 (West 1979).

14. 11 U.S.C.A. § 541 (West 1979). For example, under § 70(a)(5) of the old Act, 11 U.S.C.A. § 110(a)(5) (1976) (repealed 1978), causes of action that creditors could not reach did not come into the estate. *In re* Anderson, 345 F. Supp. 840 (E.D. Tenn. 1972).

15. 11 U.S.C.A. § 541(a)(5) (West 1979) (property that the debtor acquires within 180 days after filing the petition by bequest, devise, inheritance, property settlement with the debtor's spouse, or as the beneficiary of a life insurance policy or death benefit plan included in the debtor's estate).

16. *See id.* § 727.

17. *Compare id.* § 727(a)(9)(A) *with* Bankruptcy Act § 14(c)(5), 11 U.S.C. § 32(c)(5) (1976) (repealed 1978). *Cf.* Perry v. Commerce Loan Co., 383 U.S. 392 (1966) (wage-earner extension plan not barred by discharge in bankruptcy within previous six years).

under the Reform Act, completion of a good-faith, best-effort composition plan in which the payments total seventy percent will not raise the time bar either.[18]

Debtors who have made fraudulent conveyances within the past year are also ineligible for discharge.[19] The essence of a fraudulent conveyance is either the transfer of property by sale or mortgage for less than fair consideration while insolvent, or the retention of possession of sold or mortgaged property under circumstances designed to mislead creditors.[20] Traditional fraudulent conveyance law requires the creditor seeking relief to prove the debtor's intent to defraud, and this same element must be specifically found before a discharge is refused.[21] The debtor who has taken ill-advised steps to make himself judgment proof by putting everything in the name of a spouse or relative will therefore have to wait one year before seeking a discharge without the risk of successful creditor or trustee objection.

Failure to cooperate during the proceeding can bar the discharge,[22] but this factor is easily within the client's control and should not affect calculations of probable discharge value. Although few consumer bankrupts fail to receive a discharge, it is important to ensure that the client is eligible and does cooperate. The consequences of an unsuccessful Chapter 7 proceeding are disastrous. Nonexempt property is still liquidated, but by operation of the statute any debts scheduled in the proceeding will remain nondischargeable in any subsequent straight bankruptcy.[23]

### *b. Debts and Rights Not Affected*

The debtor who obtains a Chapter 7 discharge does not leave all his creditors behind. Several types of creditor claims may be excepted from the effect of a discharge; the Reform Act has made no major

18. 11 U.S.C.A. § 727(a)(9)(B) (West 1979). The statute presently does not require the debtor's "best effort" for confirmation of a plan under § 1325. *Contra. In re* Burrell, 2 West BANKR. REP. 650 (N.D. Cal. 1980). The Senate version of a technical amendment bill would add such a requirement. S. 658, 96th Cong., 1st Sess. § 188 (1979); S. REP. No. 305, 96th Cong., 1st Sess. 14 (1979). As before, a straight bankruptcy discharge raises the six year time bar. 11 U.S.C.A. § 727(a)(8) (West 1979).

19. 11 U.S.C.A. § 727(a)(2) (West 1979). Some older authorities are split on whether reacquisition of the property absolves the discharge bar. *Compare In re* Jacobsen, 9 F.2d 139 (D.S.D. 1925) *with In re* Williams, 286 F. 135 (W.D.S.C. 1921).

20. D. EPSTEIN, DEBTOR CREDITOR LAW IN A NUTSHELL 67-73 (2d ed. 1980).

21. Comment, 22 VILL. L. REV. 1042 (1977).

22. 11 U.S.C.A. § 727(a)(6) (West 1979).

23. *Id.* § 523(a)(9). Inability to pay the fees will now simply cause dismissal of the case. *Compare id.* § 707(2) *with* Bankruptcy Act § 14(c)(8), 11 U.S.C. § 32(c)(8) (1976) (repealed 1978).

changes here.[24] Four of these claims are most likely to affect the consumer debtor. Payments in the nature of alimony[25] and most tax debts[26] remain nondischargeable whether or not the creditor seeks a judgment to that effect in the bankruptcy proceeding. Additional situations may arise in which the affected creditors must obtain a judgment of nondischargeability.[27] Credit card companies were making greater use of the false pretenses clause of the old Act to except from discharge major debts incurred on the eve of bankruptcy,[28] and that provision has

24. 11 U.S.C.A. § 523 (West 1979). Certain educational loans were added to the nondischargeable list. *Id.* § 523(a)(8). This provision in some respects continues prior law. *See* S. REP. No. 230, 96th Cong., 1st Sess. 2 *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 1882-83. Under the old Bankruptcy Act, educational loans insured or guaranteed under the authority of the Higher Education Act of 1965 were dischargeable in bankruptcy only upon terms imposed by the Higher Education Act. *See* Education Amendments of 1976, Pub. L. No. 94-482, § 127(a), 90 Stat. 2081, 2141 (repealed 1978). Congress intended to preserve this provision of the former law when enacting the new Code in 1978, but, in attempting to transfer the relevant language from Title 20 (Education) to Title 11 (Bankruptcy), Congress erred in two respects. First, the nondischargeability provision of the Bankruptcy Code, as originally enacted, related only to loans made by governmental units or nonprofit institutions of higher education. Act of Nov. 6, 1978, Pub. L. No. 95-598, § 101, 92 Stat. 2549 (amended 1979). This failed to take into account that the student loan programs administered by the Department of Health, Education and Welfare under the Higher Education Act insure loans made by profit-making institutions of higher education as well as nonprofit institutions. Second, while the new Code nondischargeability provision did not become effective until October 1, 1979, the repeal of the nondischargeability provisions of Title 20 was effective November 6, 1978, the date of enactment of the new Code. Thus, a gap was created in the prohibition on the discharge of educational loans. *See* S. REP. No. 230, 96th Cong., 1st Sess. 1-3, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 1882, 1882-84. This was remedied on August 14, 1979, when Congress restored the old provision for the month and a half that remained before the new Code became effective. Act of Aug. 14, 1979, Pub. Law No. 96-56, 93 Stat. 387. Rather than restoring the repealed provision of the Higher Education Act, however, Congress chose to reinstate nondischargeability for educational loans by amending the old Bankruptcy Act, which had less than 50 days to live. *Id.* In addition to closing the gap in the prohibition on the nondischargeability of educational loans, the August 1979 legislation also expands the reach of the nondischargeability provision of the new Code by eliminating the requirement that a loan, if it is to be nondischargeable, must be *made* by a governmental unit or nonprofit institution of higher education. The present § 523 excepts from discharge any debt "for an educational loan *made, insured,* or *guaranteed* by a governmental unit, or *made under any program funded in whole or in part by a governmental unit* or a nonprofit institution of higher education." Act of Aug. 14, 1979, Pub. L. No. 96-56, § 3, 93 Stat. 387 (emphasis added) (codified at 11 U.S.C.A. § 523(a)(8) (West 1979)). Thus, not only is the former law relating to nondischargeability of loans insured or guaranteed under the Higher Education Act restored, but also any other educational loan made, insured or guaranteed by a state, municipality or foreign state, or agencies thereof, or made under a program funded by any nonprofit institution of higher education has become nondischargeable. *See* 11 U.S.C.A. § 101(21) (West 1979) (definition of "governmental unit").

25. 11 U.S.C.A. § 523(a)(5) (West 1979). The distinction between support payments and property settlements is maintained. Its application has been a matter of some difficulty. *See* Swann, *Dischargeability of Domestic Obligations in Bankruptcy*, 43 TENN. L. REV. 231 (1976).

26. 11 U.S.C.A. § 523(a)(1) (West 1979). In general, unpaid taxes can only become dischargeable if there has been no willfull evasion or fraud and if the IRS has been lax in its normal audit and enforcement procedures.

27. *See id.* § 523(c).

28. Affiliated Bank v. Dyer (*In re* Dyer), 4 Bankr. Ct. Dec. 180 (W.D. Wis. 1978); Nevada Nat'l Bank v. Schneider (*In re* Schneider), 3 Bankr. Ct. Dec. 175 (D. Nev. 1977); Mechanics Bank

been retained under the Reform Act.[29] The vast amount of dischargeability litigation and creditor abuse that was engendered by the old Act's prohibition on the discharge of debts incurred through the use of a false financial statement, however, should be greatly reduced by the Reform Act's requirement of four elements of creditor proof on these claims.[30]

The rough dollar effect of a discharge in bankruptcy now can be calculated for a given client in terms of property loss and debt effectively discharged. There remain two additional considerations before the full practical worth of that discharge can be predicted accurately. The liability of co-signers is not affected by a bankruptcy discharge.[31] Should a debtor have solvent co-signers, a Chapter 7 discharge will only shift the creditor focus to them. Losing the friendship of co-signers forced to pay discharged debts will diminish severely its apparent dollar worth to the client.

One aspect of bankruptcy often not fully understood is that the discharge does not in itself affect any lien that a creditor may hold. If all a bankrupt's property is liquidated, then liens can be satisfied only from sale proceeds. Particularly under the more generous set of Reform Act exemptions, however, a debtor will be able to retain much of his property, and any encumbered nonexempt property with no realizable equity will be abandoned to him by the trustee.[32] If the client is willing to give up such property, then it can be repossessed by the creditor who holds the lien on it and the matter is ended. More often, however, retention of the property will seem to be essential, and the client will have to avoid defaulting to those creditors whose liens were not eliminated successfully during the proceeding.[33]

v. DiPrisco (*In re* DiPrisco), 2 Bankr. Ct. Dec. 1724 (N.D. Cal. 1977); Fourth Nat'l Bank v. Portz (*In re* Portz), 1 Bankr. Ct. Dec. 51 (M.D. Ga. 1974); *In re* Masek, 1 Bankr. Ct. Dec. 51 (N.D. Iowa 1974).

29. *Id.* § 523(a)(2)(A).

30. 11 U.S.C.A. § 523(a)(2)(B) (West 1979) requires that creditors prove a *false, written financial statement* made with *intent to deceive* upon which the creditor *relied.* C.I.T. Fin. Servs., Inc. v. Gabriel (*In re* Gabriel), 2 Bankr. Ct. Dec. 128 (W.D. Mo. 1976), is a typical outcome. The incentive for creditors to litigate this question should be dampened further by the provision for payment of a winning debtor's attorney's fee. 11 U.S.C.A. § 523(d) (West 1979).

31. 11 U.S.C.A. § 524(e) (West 1979).

32. *Id.* § 554.

33. *See* text accompanying notes 82-84 *infra.*

### *B. Alternatives to Straight Bankruptcy*

#### 1. Chapter 13—Consumer

One might wonder why, under the Reform Act, debt repayment under a Chapter 13 plan would be considered at all. In most situations one can obtain a discharge of debt without giving up any property because of the more generous exemptions available. Chapter 13, however, may provide broader relief than Chapter 7 in two important respects. First, a discharge is available to the debtor who completes payment under a confirmed plan even though he would be ineligible under Chapter 7.[34] Second, there is much less nondischargeable debt under Chapter 13 than under 7.[35] Because creditors no longer exercise a vote in the plan confirmation process, debtors in theory can offer nothing to their creditors and still have their plans confirmed.[36] Plans offering to pay as little as to five to ten percent of creditor claims are being confirmed in Chicago[37] and Philadelphia,[38] but in some other districts much more must be offered before a Chapter 13 plan is confirmed because the judges feel that the debtor's best effort should be put forth whether or not the statute specifically requires it.[39] Thus, at least in some places, a much more extensive discharge under Chapter 13 may be available to the debtor for little more than the cost of Chapter 7.

Congress may decide to "equalize" the discharge available under

34. *Compare* 11 U.S.C.A. § 1328(a) (West 1979) *with id.* § 727(a). The Chapter 7 discharge provision states that "[t]he court shall grant the debtor a discharge, unless" anyone of nine situations is present—for example, if the debtor has received a discharge under Chapter 7 within the 6 years preceding the present petition. *Id.* § 727(a)(8). On the other hand, the court in a Chapter 13 case is required to give a discharge "[a]s soon as practicable after completion by the debtor of all payments under the plan, unless the court approves a written waiver of discharge." *Id.* § 1328(a). This discharge, however, does not apply to several specific kinds of debt. *See* note 35 *infra.*

35. The only nondischargeable debts are alimony and the unpaid balance on a home mortgage. *Compare id.* § 1328(a) *with id.* § 523. The § 1328(b) "hardship" discharge, which allows a discharge in certain cases although not all of the payments under the plan have been made, is subject to all the § 523 exceptions to dischargeability. *Id.* § 1328(c)(2).

36. *Id.* § 1325(a)(4) requires only that unsecured creditors receive no less than in a Chapter 7 liquidation for a plan to be confirmed. In most cases this need only be greater than zero. Prior law required acceptance by a majority in number and amount of unsecured creditors. Bankruptcy Act § 652, 11 U.S.C. § 1052 (1976) (repealed 1978).

37. Remarks of Professor Robert Ginsberg, Panel Discussion of Bankruptcy Reform Act, American Association of Law Schools, Section on Creditors' & Debtors Rights, in Phoenix, Ariz. (Jan. 4, 1980).

38. Remarks of Professor Arnold Cohen. *Id.*

39. Remarks of Donald Billings, Esq., of Winston-Salem, N.C. and Gerald Smith, Esq., of Phoenix, Ariz. *Id. See In re* Burrell, 2 B.R. 650 (N.D. Cal. 1980); *In re* Campbell, 3 B.R. 57 (S.D. Cal. 1980); *Cf. In re* Terry, 3 B.R. 63 (W.D. Ark. 1980) (plan approved with no payment to creditors).

Chapters 7 and 13.[40] If this happens the debtor's choice will depend largely on moral attitude about repayment and prognosis of future credit availability. Of course, the critical attitude here is that of the client and not of the attorney. Debtors who prefer to attempt repayment under a Chapter 13 plan will find their ability enhanced in that unearned interest need not be paid.[41] Additional scaling down of unsecured debt may be achieved by fashioning composition plans, and the Reform Act no longer requires creditor agreement prior to confirmation.[42] Creditors holding liens that can withstand the statutory avoidance powers need only be paid the present equivalent of their allowed secured claim over the course of the plan in order for it to be confirmed.[43]

There are two additional situations in which a debtor might prefer a Chapter 13 repayment plan over a Chapter 7 straight bankruptcy. A debtor with a co-signer problem will find that under the Reform Act the Chapter 13 automatic stay extends to creditor action against those co-signers.[44] While the stay is limited to prevent its manipulation, it will prevent coercion of co-signers while a consumer debtor pays on a less onerous schedule. In some situations this may be worth the additional dollar cost of obtaining the Chapter 13 discharge.

The debtor with significant nonexempt property will be able to retain that property[45] while repaying debts under the control and protection of the court in a Chapter 13 proceeding. As previously observed, there are likely to be few debtors with significant nonexempt property under the Reform Act. Nevertheless, one sizeable consumer group that is likely to have significant nonexempt property will be the elderly whose homes are fully paid. An elderly family living in a state whose homestead exemption is inadequate may protect its equity by using a Chapter 13 proceeding to scale debts down to a level that is within an inflation-eroded fixed income. Moreover, debtors in states that have passed statutes denying their domiciliaries the benefit of the federal exemptions[46] will find Chapter 13 relatively more attractive to the extent

40. The Senate-passed Technical Amendments Bill so provides. S. 658, 96th Cong., 1st Sess. § 188 (1979); *see* S. REP. No. 305, 96th Cong., 1st Sess. 14 (1979).

41. 11 U.S.C.A. § 502(b)(2) (West 1979).

42. *See* note 36 *supra*.

43. 11 U.S.C.A. § 1325(a)(5) (West 1979). Prior law required each secured creditor "dealt with" by the plan to accept it before confirmation. Bankruptcy Act § 652, 11 U.S.C. § 1052 (1976) (repealed 1978).

44. 11 U.S.C.A. § 1301 (West 1979).

45. *Id.* § 1327(b).

46. *See* text accompanying note 13 *supra*.

that the available state exemptions are less than what the federal exemptions would have been.

### 2. Chapter 13—Small Business

Expanded eligibility criteria have added a new dimension to Chapter 13. The small sole proprietor with regular income whose debt does not exceed statutory limits may opt for rehabilitation under Chapter 13 as an alternative to the more complicated Chapter 11.[47] Any business debtor thus eligible will face a choice among liquidation and its alternatives, and the considerations for these individuals are similar to those for consumer debtors.

The operator who is willing to have his business liquidated must either use Chapter 7 or negotiate a composition agreement with all of his creditors in order to receive a discharge of remaining unpaid debt and a personal fresh start.[48] One who simply wishes to pay off some or all of his old business debt out of future work earnings would be in much the same situation as a consumer debtor. The likelihood of nonexempt property would be somewhat higher, however, in the small business situation and these debtors would thus have more to gain by using the opportunity to retain that property afforded by the Chapter 13 option. Direct attempts to rehabilitate a business can now proceed under Chapter 13 when a workout cannot be negotiated. A Chapter 13 proceeding, however, suggests a major anomaly as yet unexplored either in the literature or in early experience with the Reform Act.

Consumer debtors in Chapter 13 are generally placed under sufficient control so that no significant new credit can be undertaken while old debts are being repaid.[49] It is not, however, possible for a business to continue and to generate earnings unless it can have access to new credit. The Reform Act does provide that a business in Chapter 13 can obtain credit in the same manner as a business in reorganization under Chapter 11.[50] The difficulty is that successful business reorganizations

47. 11 U.S.C.A. § 109(e) (West 1979). An individual with regular income is one "whose income is sufficiently stable and regular to enable such individual to make payments under a plan under Chapter 13." *Id.* § 101(24). Top debt limits are $100,000 unsecured and $350,000 secured. *Id.* § 109(e). Contingent or unliquidated debt does not count within these limits. *Id.*

48. State liquidation proceedings that provide for discharge of debt are superceded by federal bankruptcy provisions. International Shoe Co. v. Pinkus, 278 U.S. 261 (1929).

49. It was a common practice under the old Act to place such a clause in Chapter 13 plans in order to induce the creditor acceptances required for confirmation. This is no longer necessary under the Reform Act, but trustee approval is required for post-petition claims to be included in plans or modified plans. 11 U.S.C.A. § 1305(c) (West 1979).

50. *Id.* § 1304.

under Chapter 11 have been premised on the existence of an active and informed creditors committee, but the Reform Act does not provide for any similar entity in a Chapter 13 composition. While one might applaud the elimination of threshold creditor control from consumer repayment proceedings under Chapter 13,[51] one wonders where the balancing force will be found to control the small business operator who uses the proceeding to effect a drastic reduction in trade debts. Recall that at least in some areas, a more extensive discharge may be obtained in Chapter 13 under the umbrella of court protection while offering very little by way of payment.[52] Perhaps lenders will be unwilling to extend further credit to any business debtors who so use Chapter 13, but we shall have to see how the markets adjust. Attorneys who counsel small businesses are not likely to let this situation remain long unexploited.

### 3. Agreed Solutions or Workouts

Both Chapters 7 and 13 involve considerable amounts of time and money; yet without creditor agreement, debtors must use them to obtain relief. Because the vast majority of consumer bankruptcies yield nothing for creditors, however, they have a definite interest in working something out with their debtors. Indeed, most observers of the consumer credit scene report that both in theory and in practice many creditors are willing to work something out and will refrain from more drastic measures so long as regular payments can reasonably be expected.[53] Social service agencies can facilitate this process.[54] The attorney can be more helpful in a situation in which individual creditor action has been more forceful and perhaps in violation of recently enacted collection control legislation.[55] If creditors holding a significant[56]

51. Although Judge Hughes has listed elimination of creditor control among the "potential abuses of Chapter 13," Hughes, *Chapter 13's Potential for Abuse*, this Symposium, because consumer debtors have insufficient power to bargain for compositions, court control seems more appropriate for consumer 13's. Business debtors, on the other hand, do have bargaining power, and in this area Judge Hughes' remarks are on target.

52. *See* text accompanying notes 36-38 *supra*.

53. Professor Leff has fully explained the theory, Leff, *Injury, Ignorance and Spite—the Dynamics of Coercive Collection*, 80 YALE L.J. 1 (1970), and many have observed the practice, *e.g.*, Neustadter, *Consumer Insolvency Counseling for Californians in the 1980's*, 19 SANTA CLARA L. REV. 817, 823-24 (1979).

54. *See* note 2 and accompanying text *supra*.

55. *See, e.g.*, Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692-1692L (Supp. I 1977).

56. The portion held by the creditor becomes significant when the client would rather take voluntary bankruptcy than leave this amount of undischarged debt outstanding.

portion of the client's debt are unwilling to compromise, then a statutory proceeding will be necessary for the client to obtain any relief.

For the consumer debtor, a full-scale restructuring of debts by contract is nearly always an impossibility because there is nothing of value to offer the creditors in return. For the small business with Chapter 13 eligibility, however, such an agreed solution may be a more realistic possibility. The discharge from debt under a composition contract is in some respects better than under the statute. It does not raise any time bar to the later use of statutory remedies. Unless the contract specifically states otherwise, sureties are discharged as well.[57] Recalcitrant creditors can be told that a statutory proceeding with its higher overhead, lesser dividend, and absence of creditor control is their alternative. It has been estimated, however, that a dividend of more than twenty percent must be available before such propositions will interest creditors,[58] and negotiated solution remains feasible only if there have been no major levies or preferences involving the debtor's property.[59]

## II. Preparing the Case

If Chapter 7 is the client's informed choice, certain preparations are necessary before initiating the proceeding. It is not enough to simply fill out the voluminous forms and schedules filed with the petition. Two additional areas are of particular concern if the client is to obtain maximum benefit from use of the remedy. The attorney's first objective must be to see that the client's asset package will receive maximum protection under the available exemptions. While it is considered fraud to obtain new assets on credit and turn them into exempt property while contemplating bankruptcy, it is quite legal and proper to rearrange one's existing assets to take full advantage of all available shelters,[60] and the responsible attorney should so advise his client.[61]

57. Restatement of Security § 122 (1941). *Cf.* 11 U.S.C.A. Act § 524(e) (West 1979) (discharge does not affect liability of any entity other than discharged debtor).

58. *See* Davenport, *Businesses Beyond Help: Liquidation and Winding Up*, 1958 U. Ill. L.F. 585, 598 (1958).

59. Although the overhead cost of a statutory liquidation is high, creditors who have lost the individual race for assets may use the trustee avoidance powers to obtain a share in those assets. The powers are well explained in D. Epstein, *supra* note 20, at 175-226.

60. *See* Resnik, *Prudent Planning or Fraudulent Transfer? The Use of Nonexempt Assets to Purchase or Improve Exempt Property on the Eve of Bankruptcy*, 31 Rutgers L. Rev. 615, 629-38 (1978).

61. Professor Resnik explores the ethical situation and discusses the impact of cases such as Rameker v. Schwingle (*In re* Schwingle), 4 Bankr. Ct. Dec. 434 (W.D. Wis. 1978) (debtor denied discharge after following attorney's advice to reacquire homestead, which had been sold to sons under a mortgage note) Resnik, *supra* note 60, at 639-46.

A second area of preparation is to check the status of secured creditors. It is in the client's interest to determine if any secured creditors are vulnerable to the general range of trustee avoidance powers. If a security interest remains off record,[62] if the security interest was perfected more than ten days after the loan and within ninety days of the petition,[63] if the security interest was given by the client within ninety days of the petition to cover an old unsecured debt,[64] or if a lien has been taken by judicial process within ninety days of the petition,[65] the debtor's attorney should recognize that trustee avoidance action may be available. The post-bankruptcy rights of these creditors in exempt or abandoned collateral thus may be eliminated by trustee avoidance action, and this, along with the general discharge, will totally remove them from the post-proceeding picture. Although the Reform Act severely limits reaffirmation of discharged debts,[66] the elimination of faulty liens will provide the debtor a much greater measure of relief from legitimate creditor pressure after the case is closed.

## III. CLIENT SUPPORT

During the proceeding itself there are three major areas of interest to both the attorney and his client. First, the client should be made aware that presence and truthfulness during his examination at the first meeting of creditors are absolute necessities. Failure to appear or to answer proper questions are grounds for barring the discharge,[67] and it

62. *See* 11 U.S.C.A. § 544(a) (West 1979).

63. *See id.* § 547(b), (e). Section 547(e)(2)(B) states that a transfer of a security interest is made when perfected if this occurs more than 10 days after it becomes effective between debtor and creditor.

64. *Id.* § 547(b). The legislative history indicates that the trustee may avoid a transfer of a lien under this section even if the lien has been enforced by sale before the commencement of the case. *See* S. REP. No. 989, 95th Cong., 2d Sess. 87, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5873; H. R. REP. No. 595, 95th Cong., 1st Sess. 372 (1977), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6328.

65. 11 U.S.C.A. § 547(b) (West 1979). Under the old Act judicial liens were specifically covered by § 67a, 11 U.S.C. § 107(a) (1976) (repealed 1978). Under the Bankruptcy Reform Act, however, judicial liens are avoidable if they come within the general avoidance requirements of the new § 547(b). 11 U.S.C.A. § 547(b) (West 1979). This is evident because a "transfer of property" as used in § 547(b) "means every mode . . . of disposing of or parting with property or with an interest in property." *Id.* § 101(40). The legislative history indicates that the term "transfer" is adopted with certain stylistic changes from the old definition and intended to be as broad as possible. S. REP. No. 989, 95th Cong., 2d Sess. 27, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5813. The old definition specifically stated that "transfer" includes "fixing a lien upon property . . . ." Bankruptcy Act § 1(30), 11 U.S.C. § ——(1976) (repealed 1978). *See also* 11 U.S.C.A. § 547(d) (West 1979).

66. *See* 11 U.S.C.A. §§ 524(c), (d) (West 1979).

67. *Id.* § 727(a)(6).

is wise to reemphasize the continuing nondischargeability of debts should this occur. The Reform Act appears to contemplate a second appearance by the debtor to formally receive the discharge.[68] Presumably the requirements of presence and truthfulness apply here also, but unless there are reaffirmations, the exercise seems pointless.

Rejection of burdensome executory contracts subject to approval of the court[69] and elimination of faulty liens should be indicated to the trustee and care taken that the necessary orders are entered. In nonpilot districts, where trustee compensation depends on the existence of assets,[70] it is unlikely that much initiative can be expected of the trustee in most consumer cases. The burden surely will fall on the debtor's attorney to suggest helpful trustee actions when his client is the sole beneficiary.

The discharge procedures enacted in the 1970 amendments have been carried forward under the Reform Act without significant change.[71] All scheduled debts are for this purpose divided into two procedural classes. Creditors who take the position that their claims are nondischargeable under paragraphs (2), (4) and (6) of subsection (a) of section 523 must apply to the court for a timely decision to that effect in order to preserve their post-proceeding status.[72] On other potentially nondischargeable claims, any party may apply for such a decision, and it may well be in the interest of the debtor to do so. Should a creditor holding such a claim pursue it after the proceeding is closed, the debtor must assert his discharge as a defense or reopen the case and obtain a decision on the issue[73] before he can expect the bankruptcy court to enforce the injunctive effect of his general discharge.[74] The 1973 Rules contemplated an adversary proceeding for each such deter-

68. *Id.* § 524(d).

69. *Id.* § 365. Most installment purchases contracts are not "executory" for this purpose because the seller-creditor has no further obligations. Health-spa and cemetery-plot contracts, however, often remain executory and thus can be avoided.

70. *See id.* § 330. Professor Shuchman has observed an unusual incidence of "nominal asset" cases when trustee fees depend on their existence. Shuchman, *Little Bankruptcies in New England*, 56 B.U. L. REV. 685 (1976).

71. *Compare* 11 U.S.C.A. § 523 (West 1979) *with* Bankruptcy Act § 17(c), 11 U.S.C. § 35(c) (1976) (repealed 1978).

72. *See* 11 U.S.C.A. § 523(c) (West 1979).

73. Brown v. Felsen, 99 S. Ct. 2205 (1979), indicated that a state court's judgment on such issues will not bind a bankruptcy court. Thus the risk of failing to defend a state collection action may now be minimal.

74. 11 U.S.C.A. § 524 (West 1979), "voids any judgment . . . with respect to any debt discharged." In some cases this will not be established until the issue is litigated.

mination,[75] but it is likely that many such proceedings would go by default. In any event the added cost of litigating these issues would appear to be much less during, rather than after, the bankruptcy proceeding.[76]

## IV. Post-Proceeding Counseling

It may be beyond the call of duty for the general practitioner to become financial counsellor to his consumer clients, but a responsible attorney who obtains relief for these clients under the bankruptcy laws does owe them some effective counseling on the post-discharge situation. The items covered by such counseling should include reaffirmation and repayment, rights of lien creditors, and debtor recourse against creditors who illegally continue the chase.

Reaffirmation of discharged debts was both a regular occurrence and a serious problem under previous bankruptcy legislation.[77] The Bankruptcy Commission originally recommended total elimination of the practice,[78] but the Reform Act permits it in consumer cases after a court hearing at which the judge must make a series of findings and issue a stern warning.[79] There is nothing illegal about repayment of any debt discharged in bankruptcy; indeed it will at times be the right thing to do. Because post-discharge payments will no longer have the unintended effect of reviving the old contract obligations,[80] a Reform Act discharge should shift total control over repayment of unsecured debt to the debtor where it properly belongs. Moreover, there should be very few occasions when it is truly "in the best interest of the debtor" to both reaffirm and repay.[81]

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75. Fed. R. Bankr. 409.

76. Costs of litigating dischargeability issues have been held to be legitimate administrative expenses. *In re* Spisak, 2 Bankr. Ct. Dec. 1592 (D.N.J. 1977). 11 U.S.C.A. § 330 (West 1979), authorizes reasonable compensation for actual and necessary services and expenses to the debtor's attorney. Such awards qualify as priority expenses. *Id.* § 503(b)(2).

77. *Bankruptcy Act Revision, Hearings on H.R. 31 and 32 Before the Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee*, 94th Cong., 1st & 2d Sess. 761-62, 874-75, 943, 946 (1974-1975).

78. Report of the Comm'n on the Bankruptcy Laws of the United States, H.R. Doc. 137, 93d Cong., 2d Sess. 142 (1973).

79. 11 U.S.C.A. § 524(d) (West 1979).

80. The Reform Act states clearly that if the discharged debt is consideration supporting the reaffirmation, the agreement is unenforceable unless approved in court at a discharge hearing. *Id.* § 524(c). *But cf.* 1 A. Collier on Bankruptcy ¶¶17.33-.35 (14th ed. 1978); Annot., 75 A.L.R. 580 (1931) (collecting cases in which intent to reaffirm implied from a post-discharge payment).

81. 11 U.S.C.A. § 524(c)(4)(A)(ii) (West 1979). Agreements that settle dischargeability litigation or redemption issues are proper occasions for reaffirmation. *Id.* § 524(c)(4)(B). Judges who

Any rights that secured creditors retain in collateral that has been set off to the debtor as exempt or that has been abandoned by the trustee as worthless to the estate should be explained clearly to the client. The Reform Act has enhanced the ability of consumer debtors to avoid nonpurchase money liens on exempt items retained for personal use.[82] When legitimate liens remain in effect, however, there is an additional remedy available. The Reform Act specifically provides that the debtor may redeem such property by payment to the creditor in the amount of the creditor's allowed secured claim.[83] This ordinarily will be the value of the goods as estimated or appraised during the proceeding,[84] and in many cases will be considerably less than the remaining contract debt. The statute does not mention whether redemption is possible through installment payments.

Prior to 1970, the bankruptcy discharge was simply an affirmative defense available to the debtor in resisting post-proceeding collection efforts. The Reform Act carries forward and extends the efforts of a decade to transform the discharge itself into an effective remedy against creditors who illegally continue the chase. The statute now flatly states that the discharge voids judgments and operates as an injunction against court proceedings, process, *or any act* to collect the debt.[85] Thus unless there remains a litigable question about the dischargeability of a given debt, creditors should be controlled effectively by the broad injunctive effect of the Reform Act discharge. Only those who retain legitimate post-proceeding rights[86] can act without risking contempt of the issuing court. The client should be so advised and should be armed with a form letter with which to respond to illegitimate pressure.

What remains less clear even under the Reform Act is the status of noncreditor individuals or entities who would like to hold the bankruptcy against a debtor. Public bodies who wish to register their disapproval of bankruptcy may run afoul of the doctrine of *Perez v.*

take a "consenting adult" approach and routinely approve reaffirmations, however, will destroy the effect of the reform.

82. *See id.* § 522(f).

83. *Id.* § 722.

84. *Id.* § 506(a). This section simply provides that value will "be determined in light of the purpose of the valuation and of the proposed disposition or use of such property." *Id.*

85. *Id.* § 524(a). The phrase "or any act" was added to make it clear that extra-judicial conduct to collect a debt was in violation of the discharge. *Compare id. with* Note, *Section 14f(2) of the Bankruptcy Act: Half a Loaf to the Bankrupt*, 14 Hous. L. Rev. 486 (1977).

86. *See* text accompanying notes 24-33 *supra*.

*Campbell*[87] and its Reform Act embodiment in section 525.[88] There will necessarily be tension between societal disapproval of bankruptcy and the fresh start policy reemphasized in the Reform Act. The Supreme Court decision in *Perez* sought to put some teeth into the fresh start by grounding it on the notion of supremacy. The Reform Act carries the idea forward by providing that "governmental unit[s]" are forbidden to take discriminatory or coercive action against debtors "solely because" they have availed themselves of the statutory remedy.[89] Problems of proof are significant. Ostensible reasons for firing employees relieved of their debts may be hard to discredit. Moreover, other strong policy factors must be considered when, for instance, a bar applicant sheds his educational debts on the eve of lucrative employment.[90] At present the client can only be told that there is a basis for resisting discriminatory treatment and be encouraged to seek counsel if such treatment occurs.

The situation would seem to be more difficult when a private entity seeks to register similar disapproval. So long as the entity is not a creditor covered by the automatic injunctive effect of the discharge, there is no express statutory redress. It is to be hoped, however, that the bankruptcy courts will remain amenable to debtor pleas for protection of the fresh start against employers who take actions that would be forbidden to governmental units under section 525.[91] The attorney who institutes a remedial proceeding should remain available to reopen the proceeding and seek protection for the client from the bankruptcy court when this is warranted.

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87. 402 U.S. 637 (1971).

88. 11 U.S.C.A. § 525 (West 1979).

89. *Id.*

90. *Compare* Florida Board of Bar Examiners *re* Groot, 365 So. 2d 164 (Fla. 1978), *with* Florida Board of Bar Examiners *re* G.W.L., 364 So. 2d 454 (Fla. 1978).

91. Local Loan v. Hunt, 292 U.S. 234 (1934), established the availability of post-proceeding injunctive relief to protect the fresh start, and nothing in succeeding legislation should diminish its effect.