Chapter 13 Saves the World!

By Arthur W. Rummler

In the pantheon of catchy idioms, Chapter 13 bankruptcy[1] could easily be referred to as: the Rodney Dangerfield, *persona non grata*, odd man out, third wheel or the black sheep of the consumer bankruptcy world. Chapter 13 is just not as popular as Chapter 7. Indeed of the total bankruptcy cases filed in 2016, only 38% were initiated as Chapter 13 cases.[2] The vast majority of cases were filed under Chapter 7 with a very small percentage as Chapter 11. Further, Chapter 13 cases have a high rate of failure. The exact statistical information can be difficult to measure, but according to one study, only 33% of cases filed received a discharge.[3] The remaining 67% were either dismissed without confirmation, converted to Chapter 7 or dismissed after confirmation. Daunting numbers to say the least. But, enough doom and gloom, Chapter 13 may not be perfect for everyone, but it can do some extraordinary things when it comes to restructuring or consolidating debts for the average consumer. It may, in fact, be able to save the world.

Types of Bankruptcy Cases for Consumers

As most practitioners know, there are two general types of bankruptcy cases available to the typical consumer. Chapter 7 is the most common and is sometimes referred to as *liquidation*. Chapter 13 is sometimes referred to as a *wage earners plan* or a *plan of reorganizatio*n. The two Chapters are very different.

Chapter 7

Very briefly, Chapter 7 bankruptcy is filed so that a person can get a discharge of debt and a fresh start. In theory, the debtor gives up his or her assets and property in exchange for a discharge or forgiveness of debt. In practice, debtors can retain some property as exempt under applicable law[4]. Exemption laws are not overly generous though and a debtor has to consider if her or she is willing to part with some assets in exchange for a fresh start. And just like the late night commercial says, it is possible to keep your home or car in bankruptcy, but only if there is not too much equity to exceed the available exemptions and only if the debtor agrees to pay the loan after the bankruptcy.

Chapter 7 has many facets and can be very complicated. Debtors want to retain their assets. Creditors want their claims paid by the bankruptcy trustee liquidating those assets. Debtors want a discharge of debt. Creditors would prefer the debt not be discharged. Creditors can sometimes prevent a discharge under certain circumstances. For instance, if a debt is incurred by fraud or an intentional tort it can be declared as non-dischargeable. Or, if the debt is of a certain category, such as child support, maintenance or debts owed to the government.[5] This only scratches the surface of complexity to Chapter 7 cases. So much for a brief explanation!

Chapter 13

The hero of this article is Chapter 13. Chapter 13 is a debt repayment plan. A debtor proposes a plan to repay all or some of his or her debts through a Chapter 13 plan. A plan can be for as little as 36 months or as many as 60. There are many reasons why a person would file a Chapter 13 case instead of a Chapter 7.

1. Chapter 13 is the common name for cases under Title 11 U.S.C. Section 1301 et. seq.
2. As captured on March 12, 2017 from:http://www.uscourts.gov/sites/default/files/data_tables/bf_f2_1231.2016.pdf
3. Captured on March 12, 2017 from https://www.philadelphiafed.org/research-and-data/.../q4/li_chapter-13-filings.pdf
4. See generally 735 ILCS 5/12-1001 et. seq. listing the most common examples, but is not exhaustive.
5. See 11 U.S.C Section 523 for specific debts that are non-dischargeable in bankruptcy.

First and foremost, any bankruptcy case starts with a thorough review and consultation regarding the individual debtor's particular debt situation. There are no cookie cutter cases. Since 2005 and the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") bankruptcy cases are subject to income caps that may disqualify people earning higher incomes.[6] If someone can't qualify for Chapter 7, then a Chapter 13 may be the answer. However, not everyone can do Chapter 13. If your reasonable monthly expenses exceed your income, you could be disqualified from Chapter 13 because your income is too low. Chapter 13 requires net disposable income to fund the plan of reorganization. An in depth analysis of income and expenses will tell if someone is a good candidate for Chapter 13. Assuming you qualify to file Chapter 13, what are some of the things that you can do through your Chapter 13 case?

Benefits of Chapter 13

Avoiding Foreclosure

One popular use Chapter 13 is to stop a foreclosure. Picture a person who has come through some harrowing financial circumstances and is facing foreclosure. Perhaps they were unemployed for a time or they went through a bitter divorce and got behind on the mortgage. But now things are working out and they have the means to pay the mortgage as it comes due. If they have more income than expenses, then that "disposable income" can be committed to fund a Chapter 13 Plan. The Plan can be drafted to pay back the mortgage arrears and protect the home from foreclosure. The debtor makes 2 payments each month for the house; the current monthly mortgage and a portion of the arrearage (via the Chapter 13 plan). The same can be done with a car loan or other secured debt whereby the debtor faces loss of the asset from non-payment.

Stripping 2nd Mortgage Liens

In recent years, the downfall in the real estate market has highlighted a previously little used provision of the bankruptcy code with respect to Chapter 13. That is the ability to redefine 2nd mortgage liens as unsecured debt and thus eliminate them through a Chapter 13 Plan. This is commonly referred to as *lien stripping*.

6. BAPCPA was enacted due to perceived abuses in the bankruptcy laws. One of the bill's sponsors specifically stated that the bill was designed to make it "more difficult for people to file for bankruptcy". See: https://www.grassley.senate.gov/news/news-releases/opening-statement-sen-chuck-grassley-bankruptcy-reform-hearing as captured on March 12, 2017.

Lien stripping is the use of the bankruptcy code to determine the value of collateral securing a second (or third, and so on) mortgage on residential property and then, if appropriate, deeming any liens that have no collateral for the lien to attach to as "unsecured". Once the lien is stripped of its secured status is treated as a general unsecured claim in a bankruptcy case and can be paid less than the full amount of the loan. Depending on the plan proposed by the debtor, the general unsecured creditors could get as little as 10% of their claimed amount, and in extraordinary circumstances even less.

In order to strip a lien, the debtor must provide an honest valuation of the collateral and also analyze the amounts of existing liens. For example, assume that the debtor has a first and second mortgage on a family home of $200,000 and $50,000 respectively. If the debtor obtains a fair valuation of the property for less than the balance of the first mortgage, say $190,000 for this example, then the second or subsequent mortgage liens can be deemed as unsecured. These can then be stripped in a Chapter 13 Bankruptcy Case. Again, they become unsecured claims and are paid according to the provisions in the Chapter 13 plan for those types of creditors.

Cramdown of Car Loans

It is possible in a Chapter 13 to "cramdown" the balance of a loan secured by an automobile to the fair market value of the collateral. Take the example of a debtor who owes $20,000 on a car loan where the vehicle has a market value of $12,000. By using the Chapter 13 plan, the debtor can propose to pay only the secured amount back to the creditor in full, with the balance being treated as a general unsecured claim. The mechanics are similar to lien stripping in the real estate example above. There is however one important catch: the loan must be

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older than 910 days to qualify for this option. The reasoning being that a car lender who provides purchase money for the car loan (a purchase money secured lender) should have some protection against the loan being modified by Chapter 13 for the first 910 days which is approximately 2.5 years. A refinanced car loan or a title loan would not get the protection since they are not a purchase money secured loan.

Reduction in Interest Rate of Car Loan

Similar to the "cramdown" of a loan secured by property such as a motor vehicle, a debtor can also obtain relief from excessive interest rates charged on a car loan.[7] Assume that the debtor has a car loan of 25% interest (unfortunately not uncommon for less than A plus borrowers). If the debtor puts the car loan into the Chapter 13 plan and proposes to pay it back through the plan, the interest rate can be reduced to the prime rate plus an additional rate to satisfy the interest on the loan. The additional rate above the prime rate is a moving target based on the circumstances, but is generally about 2 percent. This significantly reduces the interest paid by the debtor on the loan and can be beneficial in cases of very high loan interest rates.

Curing Child Support or Maintenance Arrears

In the arena of family law, it is common to see litigation over past due child support or maintenance. When a client is faced with a large arrearage and possible negative consequences for non-payment, Chapter 13 can be the answer.

First and foremost, Chapter 13 won't change the fact that the debt *must* be paid. The bankruptcy code is very specific that child support and maintenance – or "domestic support obligations" in bankruptcy parlance[8] – are both non-dischargeable in bankruptcy.[9] But, that doesn't mean you can't use the Chapter 13 plan to spread those payments out over a 60 month period. It may be much more beneficial to the debtor to opt for a 60 month repayment period over the terms and conditions imposed under other circumstances. But, for the Chapter 13 plan to proceed and remain in good standing, the debtor must be current on all future payments of child support or maintenance that arise during the plan.

Reducing Certain Debts Incurred During Divorce

As demonstrated above, certain debts from a divorce are not subject to reduction in a Chapter 13 case. Domestic Support Obligations are sacrosanct and cannot be discharged. However, there are other debts sometimes incurred during the process of a divorce that can be modified. Assume that one spouse is ordered to pay the other spouse a sum of $50,000 as a property settlement and that is a provision contained in the Judgment for Dissolution of Marriage. Perhaps it is for a share of some marital asset that is being divided in the divorce. Whatever the reason, as long as the debt is not in the nature of a Domestic Support Obligation, it can be modified and reduced in a Chapter 13 plan. Debts of this nature are not dischargeable in Chapter 7.[10] But, in Chapter 13, they are dischargeable as long as all of the other requirements of the Chapter 13 plan are being met.

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Payment of Tax Debts

Similar to child support and maintenance arrears, debtors can pay back taxes through a Chapter 13 plan. Income taxes are generally non-dischargeable as priority debts owed to the government. However, in some cases, the tax debts can be discharged if certain requirements are met. Typically, the Internal Revenue Service will file a claim in the bankruptcy case and outline specifically which debts are priority debts (and thus must be paid back 100% over the life of the plan) and which debts are non-priority (and thus treated as general unsecured debt). This can be of great benefit when a debtor is facing collection action or about to lose property due to unpaid taxes.

7. See Till v. SCS Credit Corp., 541 U.S. 465, 479-80 (2004)
8. See 11 U.S.C. Section 105
9. See 11 U.S.C. Section 523(a)(5)
10. See 11 U.S.C. Section 523(a)(15) and 11 U.S.C. section 1328(a)(2). The latter does not include section 523(a)(15) in the exceptions to discharge.

Co-debtor Stay

The well-known "secret" power of the bankruptcy code is the automatic stay.[11] Volumes could be written solely about the automatic stay and the effect is has on creditors and debtors. Essentially, the automatic stay ceases almost all actions against a debtor for commencement, continuation and or the collection of a debt. In Chapter 13, the automatic stay is in effect for the duration of the Chapter 13 case (unless relief is granted for cause).[12] As stated above, that can be for up to 60 months. One additional benefit to Chapter 13 is the extension of the automatic stay to co-debtors of the bankrupt debtor.

One example might be a former spouse who was the joint borrower on a mortgage loan that went into default and now has significant arrears. If the debtor proposes to pay the arrears on the mortgage in full through the Chapter 13 plan, then the mortgage lender must cease any collection efforts against the joint borrower. The creditor is stayed as to any action against the co-debtor provided the creditor is getting paid in the Chapter 13 plan.

Proposing a Viable Chapter 13 Case

While the subject of proposing a viable Chapter 13 case that can actually be confirmed by the bankruptcy court is beyond the scope of this article, there are basic elements that can be summarized generally.

A Chapter 13 Debtor must commit all net disposable income to the Chapter 13 plan for the required term of the plan. Thus, in many cases, if you take the Debtor's income and subtract reasonable living expenses, you can arrive at a disposable income figure.

Adding another level of complexity to the analysis is the BAPCPA bankruptcy amendment from 2005 that mandates certain debtors to pay a minimum amount to unsecured creditors through the Chapter 13 Plan. This minimum amount is determined by averaging the debtor's income over the prior six months and projecting that into an annualized income. That is then compared to the median income for households in the debtor's community of the same household size. If the annual income exceeds the median income, 2 things happen: 1) the debtor must be in a 60 month chapter 13 plan (as opposed to a 36 month case); and 2) the amount of disposable monthly income is determined by application of the Bankruptcy Means Test.

The infamous Bankruptcy Means Test is a long form analysis tool. The bankruptcy attorney analyzes the client's information and runs it through the means test. The ending result is the disposable income the debtor must commit to pay to unsecured creditors for the term of the plan. "It's complicated" is the best way to sum it up. But, let's take an example.

Assume that a debtor has an average income of $5000 per month over the last six months. His household size is one. He is in debt and he is also most likely lonely.

This analysis computes his annual income at $60,000. Comparing that to the median income in his DuPage County community, he is over the median income by about $12,000. Therefore, the term of his Chapter 13 must be 60 months.

Further long form analysis of the debtor reveals that after taking all of the allowable deductions to income allowed in the means test, that there is a bottom line monthly net disposable income from of $400. Thus, the debtor must pay at least $400 per month to his general unsecured creditors over 60 months. This will amount to $24,000 over 60 months.

If the debtor owed $100,000 in general unsecured debt (e.g. credit cards, medical bills, stripped off 2nd mortgage), those creditors would receive 24% of their claims through the Chapter 13 case. He will get a discharge of the remaining 76% of the unsecured claims. After 60 months, he will be debt free and ready to conquer the world.

Perhaps Chapter 13 can't really save the world. But it can save your client financial disaster if planned and executed correctly. Fortunately, the custom in our region is for prospective debtors to receive a free initial consultation from almost all local bankruptcy lawyers. So, they have nothing to lose by learning their options. If the client is able to turn around their financial woes through a Chapter 13 case, then who knows, maybe they can be a positive force for good and go out and save the world. □

11. See 11 U.S.C. Section 362
12. See 11 U.S.C. Section 1301(a)