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# CONSUMER INSOLVENCY COUNSELING FOR CALIFORNIANS IN THE 1980's

Gary Neustadter\*

## INTRODUCTION

Attorneys who counsel insolvent debtors in California will have significant new tools for that task in the 1980's because of the recent enactment or amendment of state and federal law affecting three closely related concerns of debtors: collection conduct, wage garnishment and bankruptcy (both liquidation and what was formerly termed wage earners' proceedings). Effective insolvency counseling will require a thorough familiarity with the federal Fair Debt Collection Practices Act,<sup>1</sup> which governs the conduct of collection agencies,<sup>2</sup> with the recently enacted provisions of the California Civil Code which govern the conduct of debt collectors and debtors,<sup>3</sup> with the Employees' Earnings Protection Law<sup>4</sup> (the formal title of California's new wage garnishment law), and with the recent revision of federal bankruptcy law.<sup>5</sup>

While this article focuses on the impact of this legislation

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1. 15 U.S.C. §§ 1692-1692o (Supp. I 1977).

2. See note 39 and accompanying text *infra*. The conduct of collection agencies in California is also governed by provisions of the Business and Professions Code and by administrative regulations promulgated by the California Bureau of Collection and Investigative Services. CAL. BUS. & PROF. CODE §§ 6860, 6863, 6947, 6947.1 (West 1975 & Supp. 1979); CAL. ADMIN. CODE tit. 16, §§ 606-641 (1978). A fuller discussion of the law governing the conduct of collection agencies as well as the conduct of persons who seek to collect debt on their own behalf follows in the text accompanying notes 35 - 76 *infra*.

3. Fair Debt Collection Practices (Robbins-Rosenthal) Act, CAL. CIV. CODE §§ 1788-1788.32 (West Supp. 1979).

4. CAL. CIV. PROC. CODE §§ 723.010-.154 (West Supp. 1979).

5. See text accompanying notes 113-359 *infra*.

upon counseling for the individual consumer debtor<sup>6</sup> seeking relief from insolvency, some of the legislation is also clearly relevant to counseling of debtors, including judgment debtors, who are not experiencing general financial distress but who may simply be seeking to resist or forestall collection of an individual debt or enforcement of an individual judgment. Implications for the counseling of these debtors will, hopefully, become apparent in the discussion of insolvency counseling.<sup>7</sup>

In some ways it would have made more sense for this assortment of legislation to have come from one legislative body with a mind to evaluate, and restrike (if necessary), the balance between effective creditor remedies and important protections for debtors experiencing financial distress. One legislature, with that goal, might have been able to more effectively consider and then manipulate the relationship between wage garnishment and bankruptcy, or the relationship between wage garnishment and welfare, or the relationship between harsh collection practices and bankruptcy.<sup>8</sup> However, that ideal ap-

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6. I have chosen the phrase "individual consumer debtor" and have titled this article *Consumer Insolvency Counseling for Californians in the 1980's* because of my desire to focus upon the individual, generally employed, whose insolvency arises from debts incurred primarily for personal, family or household purposes and who is not a sole proprietor or a partner of a partnership. I have avoided the phrase "wage earner" both because that phrase is frequently associated with Chapter XIII wage earners' proceedings under the repealed Bankruptcy Act (only one tool for insolvency counseling) and because insolvency counseling is frequently required for persons involuntarily unemployed or unemployed because of their housekeeping or child rearing responsibilities in the home. Much of what is said in the article will, of course, bear upon counseling for persons who do not fit the above description.

7. The reforms of federal bankruptcy law also clearly impact significantly on business insolvency counseling. That subject, addressed and to be addressed by others, will not be treated here. For a useful introduction to business insolvency counseling under the revised bankruptcy law, see Downey, Ferriell and Pfeiffer, *The Proposed Bankruptcy Reorganization Provisions: A Comparison of the Current Law with Chapter 11 of H.R. 8200 and S. 2266*, 18 SANTA CLARA L. REV. 567 (1978); Trost & King, *Congress and Bankruptcy Reform, Circa. 1977*, 33 BUS. L. 489 (1978).

8. There are studies of the relationship between wage garnishment and voluntary bankruptcy. Compare D. STANLEY & M. GIRTH, *BANKRUPTCY: PROBLEM, PROCESS, REFORM 28-32* (1971) (voluntary filings before passage of the federal Consumer Credit Protection Act) with Shuchman & Jantscher, *Effects of the Federal Minimum Exemption from Garnishment on Nonbusiness Bankruptcy Rules*, 77 COM. L.J. 360 (1972) (concluding that as a result of the federal Consumer Credit Protection Act, in states where the Act increased the amount of wages exempt from execution, voluntary bankruptcy filings declined) and *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 1st & 2d Sess., pt. 2, at 776* (1975) [hereinafter *House Hearings*] (statement of Professor Philip Shuchman, University of Connecticut School of Law) (wage garnishment not a major cause of bankruptcy). I am unaware of any

pears unrealistic because those relationships are enormously complex, because the ideal would clash with principles of federalism, and because interest group pressures would be so strong as to make the task nearly impossible.

Insolvency counselors are left, then, to ply their trade with bits and pieces of different laws, enacted at different times by different sovereignties with different constituencies. This article is intended to help build an understanding of how the newly shaped pieces of the same puzzle fit together. To do so, the article first considers the problems faced during the initial client interview and, in doing so, paints a broad picture of the counseling alternatives. Following that overview, the article discusses, in turn, specific provisions of the new legislation governing collection practices, wage garnishment, voluntary bankruptcy (liquidation), and the adjustment of debts of an individual with regular income.

#### COUNSELING ALTERNATIVES

It is a formidable task for the consumer insolvency counselor to remember and maintain technical mastery of the variety of alternatives for relief from insolvency and then in each case to be able to draw upon such knowledge to facilitate the client's choice of the most economically and emotionally satisfying alternative. The task is the more difficult because of the importance of responding effectively as a counselor to a person whose request for assistance cries out for understanding and empathy. Many debtors are terribly embarrassed by their inability to cope with their financial affairs, even if their difficulties were caused by factors beyond their control. Many debtors are frightened about the future and this fear may have been heightened by nasty and often illegal collection efforts. Many debtors feel guilty about their inability to pay debts and find morally objectionable any alternative that will relieve them of their financial obligations. They may be torn terribly between that guilt and the felt necessity to obtain a fresh start. Effective

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studies relating harsher wage garnishment to increases in the number of persons seeking welfare or unemployment compensation, but my intuition suggests that a correlation exists. I am similarly unaware of any studies relating harsh collection practices to the rate of voluntary bankruptcy but again suspect some correlation. The statement of findings and purpose of the Fair Debt Collection Practices Act states that "[a]busive debt collection practices contribute to the number of personal bankruptcies. . . ." 15 U.S.C. § 1692(a) (Supp. I 1977).

insolvency counseling, then, must merge compassion with knowledge.

In the last decade, some members of the legal profession and some educators and students in the nation's law schools have gained heightened awareness of and sensitivity to this human dimension of legal counseling. They have been moved to believe, as I believe, that compassion, understanding and empathy are fully as important to legal counseling as is technical mastery of the law.<sup>9</sup> Some people do not share this view, however, or at least have not looked at legal counseling from this additional perspective. Following their survey of law student, law teacher and law school alumni reaction to hypothetical problems involving marriage and family conflicts, Thomas Shaffer and Robert Redmount have written:

These problems cry out for creative, personal concern, for some sort of personal relationship between lawyer and client. They are occasions for compassion. . . . Few lawyers, at any level of maturation, were interested in how their clients felt. They found no professional usefulness in how *they themselves* felt. They saw themselves as mechanics. . . . Almost no one showed concern for the emotional turmoil of clients, not even a divorce client who demonstrated instability and hinted at suicide.<sup>10</sup>

Our findings confirm what some legal educators think and others know: Legal education advances the view that law is a technical enterprise. The lawyer's professional strength and power are considered to be in his ability to

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9. Two recent law books for law students reflect increased concern for the personal dynamics of the attorney-client relationship: G. BELLOW & B. MOULTON, *THE LAWYERING PROCESS: MATERIALS FOR CLINICAL INSTRUCTION IN ADVOCACY* (1978); L. BROWN & E. DAUER, *PLANNING BY LAWYERS: MATERIALS ON A NONADVERSARIAL LEGAL PROCESS* (1978). Those books also provide a useful beginning reference to some of the other writing on the subject. See also D. BINDER & S. PRICE, *LEGAL INTERVIEWING AND COUNSELING: A CLIENT-CENTERED APPROACH* (1977). Some of my colleagues at the University of Santa Clara Law School share this concern. Recently, the Santa Clara Law School faculty approved a two year experimental program offering law students the opportunity to enroll for credit in selected courses offered in the University's counseling degree programs.

My attitudes toward lawyering and the legal education process have been heavily influenced by my continuing association with legal educators who are participating in the Columbia University School of Law's *Project for the Study and Application of Humanistic Education in Law*, initially funded by a grant from the National Institute of Mental Health. Some initial writing emerging from the work of the people in the Project appears at *Symposium on Legal Education*, 53 N.Y.U. L. REV. 291 (1978).

10. T. SHAFFER & R. REDMOUNT, *LAWYERS, LAW STUDENTS AND PEOPLE* 5 (1977).

analyze and conceptualize in legal terms. . . . Because of the emphasis placed on legal competence, rather than human competence, concern about people may even be regarded as an undesirable incursion into the 'real' business of law. It is often the orderliness of solutions that is preferred, rather than the appropriateness of a solution for clients. . . .<sup>11</sup>

It is my wish that this article's focus upon substantive law not advance the view that insolvency counseling is solely a technical enterprise.

In seeking relief from insolvency, attorney and client can choose from a wide range of alternatives. They may explore ways in which income of the debtor or of the debtor's family can be increased or basic living expenses reduced to enable the debtor to cope with present and future budget demands as well as with past due obligations. The client may be able to refinance debts which are currently due, particularly if collateral, such as equity in a residence, is available to secure the loan. Attorney or client may be able to negotiate a formal composition or extension of past due obligations; this may require or may be facilitated by liquidation of some of the client's assets. Attorney and client may seek to forestall some or all collection efforts by requesting a delay in payments, by invoking protections against unfair collection practices, and by asserting the full range of debtor protections against execution upon a judgment, including protections against wage garnishment. Attorney and client may seek to resist claims of individual creditors by asserting available defenses or counterclaims. Finally, the client may file a petition for liquidation and discharge or a petition for adjustment of debts under federal bankruptcy law. In order to help the client choose an appropriate solution, the insolvency counselor must understand the details and consequences of each alternative.

#### *Increasing Income or Reducing Expenses*

Increase in family income or reduction of basic living expenses (housing, food, transportation, clothing, utilities and medical care) is a rather obvious yet often overlooked possibility for relief from financial distress. Additional funds made available by increasing income or reducing expenses may be

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11. *Id.* at 128.

sufficient to enable the debtor to cure defaults in payment and maintain future payments on existing debts. Increase in the debtor's salary may be foreseeable in either the debtor's present or alternative employment (or possible future employment if not presently employed). To supplement family income, the debtor may be willing and able to moonlight for a time or other family members might obtain part or full time employment. In addition, slightly larger income will be available if the debtor or members of the debtor's family are not claiming the full number of income tax withholding exemptions to which they are entitled.

Some debtors may also be able to reduce basic monthly living expenses. Most debtors do not overspend for food or utilities; some do overspend for housing, transportation, or clothing.<sup>12</sup> Although frequently inconvenient or unpalatable, it is sometimes possible for the debtor and the debtor's family to relocate from expensive to less expensive rental housing or sell an automobile for which high monthly payments are required, and then purchase, if necessary, an automobile for which monthly payments are considerably lower. Alternatively, the debtor might lease an automobile, a transaction for which the "down payment" and monthly payments are usually considerably lower than comparable payments in a purchase transaction.<sup>13</sup> The possibility of reducing other expenditures should also be explored.

If the total amount of debt is not overwhelming and if the debtor or debtor's family is willing and able to increase income or reduce expenses, counseling to those ends is certainly appropriate.

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12. These and some other factual assertions in the text derive from my personal experience in counseling approximately two hundred clients at the Legal Aid Society of Santa Clara County during the past two years.

13. Federal law regulates consumer lease transactions. Consumer Credit Cost Disclosure (Truth in Lending) Act, §§ 181-186, 15 U.S.C. §§ 1667-1667e (1976); Regulation Z, 12 C.F.R. § 226.15 (1978) (Consumer leases). California law also regulates consumer automobile leases. CAL. CIV. CODE §§ 2985.7-2990 (West Supp. 1979). Both assure that the consumer lessee is not saddled with large balloon payments at the termination of the lease. 15 U.S.C. § 1667b (1976); CAL. CIV. CODE § 2988 (West Supp. 1979). Neither act prescribes uniform terminology for payments made at the inception of the lease or during the term of the lease. Compare Regulation Z, 12 C.F.R. § 226.15(b) (1978) and CAL. CIV. CODE § 2985.8 (West Supp. 1979) with Regulation Z, 12 C.F.R. § 226.8(c)(2) (1978) (prescribed terminology in credit sale transactions).

### *Refinancing Debts*

A debtor may seek to refinance debts as an alternative to, or in addition to, increasing income or reducing living expenses. Refinancing can take a number of forms, can be sought from several sources, and can relate to all or any part of the individual's existing debts.

Sometimes consumers can obtain bill consolidation loans from personal property brokers.<sup>14</sup> Interest rates are high and such lenders usually insist upon securing the loan by taking a security interest in the household goods or automobile of the debtor.<sup>15</sup>

Consolidation loans may be available from other sources. Other institutional lenders may be willing to loan at lower rates if convinced of the ability of the debtor to repay or if sufficient collateral is available to secure the loan. One source of collateral, of course, is equity in a residence and the attorney can suggest to the homeowner debtor that he or she consider refinancing on the basis of real property security. An individual lender, usually a relative or close friend, may be willing to lend substantial sums without collateral. Many clients will be extremely reluctant, however, to seek financial help from relatives or will have already exhausted that source.

Refinancing of an individual debt obligation may also be sufficient to relieve the financial distress of the client. A large car payment or other large loan payment may be reduced and the term of the loan extended, particularly if the remaining term of the loan is relatively short and if the value of any existing collateral continues to be sufficient to secure the loan. Surplus funds thus generated can then be devoted to other purposes.

### *Composition or Extension*

The client, individually or with the assistance of the attorney, may be able to negotiate a formal settlement with some or all creditors that provides for a reduction in the total amount

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14. Personal property brokers, such as Beneficial Finance Co. and Household Finance Co., are regulated by provisions of the California Financial Code. CAL. FIN. CODE §§ 22000-22653 (West 1968 & Supp. 1979).

15. CAL. FIN. CODE §§ 22451-22451.5 (West 1968 & Supp. 1979) set out the maximum interest charges which the lender may receive for a loan. The lender may take a security interest in the borrower's personal property as collateral for the loan, *id.* § 22457, but may not take a security interest in real property of the borrower if the principal amount of the loan is less than \$5,000, *id.* § 22466.



of debt due (composition) or an extension of time in which to pay (extension).<sup>16</sup> The client's negotiating position may be strengthened by communicating to creditors the threat that liquidation or adjustment of debt proceedings may be initiated failing their cooperation. Negotiation of extensions is frequently possible in connection with credit card obligations, medical bills and debts owed a personal property broker.

Compositions or extensions may be facilitated by liquidation or surrender of assets. For example, a debtor may be able to sell an automobile which is not immediately necessary for the family and use the proceeds to partially or fully pay a debt. Immediate partial payment of a debt may be acceptable to a creditor in full satisfaction of an obligation.<sup>17</sup> Some debts may be extinguished by voluntary surrender of property subject to a security interest. Property purchased under a retail installment contract may be returned to the seller; surrender of the collateral (other than an automobile) effectively extinguishes the debt because the California retail installment sales law prohibits deficiency judgments.<sup>18</sup>

### *Forestalling Collection or Resisting Execution*

Recent legislation governing collection conduct provides significant tools to resist collection efforts of creditors or their assignees.<sup>19</sup> The debtor, in some circumstances, may even insist that extra-judicial collection efforts cease entirely, even though not harassing or inconvenient, by simply informing the debt

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16. There may be little practical difference between refinancing debt, negotiating a formal extension of an existing debt or debts, or requesting that the creditor defer collection. However, the text treats these alternatives separately because the form and sometimes the substance of these alternatives may differ. For example, one might refinance a debt with a personal property broker by negotiating and executing an entirely new loan or negotiate a formal extension of a secured automobile loan from a bank or simply request a department store to wait three months before expecting any payments on a revolving charge account.

I do not treat assignments for the benefit of creditors because that remedy is uneconomical except in business insolvency counseling.

17. The promise of the creditor to forego future attempts to collect the remaining amount originally owing is supported by adequate consideration if the promise is in writing or if payment is made prior to the time the balance in full would have been due. CAL. CIV. CODE § 1524 (West 1954) (part performance of an obligation accepted by creditor in writing extinguishes the obligation); *id.* § 1541 (written release); *Petroleum Collections Inc. v. Sulser*, 265 Cal. App. 2d Supp. 976, 70 Cal. Rptr. 537 (1968); *Blumer v. Madden*, 128 Cal. App. 2d 319 (1932).

18. CAL. CIV. CODE § 1812.5 (West 1973).

19. See text accompanying notes 35-76 *infra*.

collector of the debtor's unwillingness or inability to pay and by requesting that further extra-judicial collection efforts cease.<sup>20</sup>

Explanation to a creditor of a debtor's current financial emergency, especially if coupled with assurances of reasonably prompt resumption of payments, will frequently delay collection efforts and provide the debtor valuable additional time. Even if a debt collector sues to enforce an obligation, the minimum thirty day period between service of summons and complaint and entry of default judgment additionally delays the potential for execution upon property of the debtor.

Execution against property of the individual consumer debtor usually consists of wage garnishment. Federal law automatically protects most of a debtor's wages and California law offers additional protection, in some cases, upon a showing of necessity.<sup>21</sup> Execution against other property of the debtor is less frequent. Creditors usually cannot levy against household belongings of the debtor<sup>22</sup> and execution on a debtor's automobile may be impossible.<sup>23</sup> A creditor may be able to obtain a lien against real property used as a residence but will usually not

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20. See note 53 and accompanying text *infra*.

21. See notes 84-87 and accompanying text *infra* and text accompanying notes 95-97 *infra*.

22. Household furnishings, appliances, wearing apparel and similar specified items are exempt from execution (except in an action to foreclose a lien on such property or in an action for their purchase price) if ordinarily and reasonably necessary to and actually used by the debtor or the debtor's resident family. CAL. CIV. PROC. CODE §§ 690.1, 690.52 (West Supp. 1979). The California courts have determined what is "ordinarily and reasonably necessary" by reference to the debtor's station in life; this expansive reading of the exemption certainly discourages execution upon these kinds of property. *Newport Nat'l Bank v. Adair*, 2 Cal. App. 3d 1043, 83 Cal. Rptr. 1 (1969); *Independence Bank v. Heller*, 275 Cal. App. 2d 84, 79 Cal. Rptr. 868 (1969).

The California Law Revision Commission is currently drafting a proposed comprehensive reform of the state's enforcement of judgment provisions, including its exemption provisions. Among the Commission's proposals is one which would narrow the exemption for household furnishings and like items by establishing an upper limit to the value of any individual item. CAL. L. REVISION COMM'N, TENTATIVE RECOMMENDATION RELATING TO ENFORCEMENT OF JUDGMENTS § 707.520 (unpublished staff draft Feb. 1979) (on file at Santa Clara Law Review)[hereinafter cited as COMM'N TENTATIVE RECOMMENDATION].

23. A debtor's equity in one automobile is protected to the extent of \$500. CAL. CIV. PROC. CODE § 690.2 (West Supp. 1979). Unless the debtor owns two or more vehicles, the sheriff may not receive any bid in an execution sale unless the bid exceeds the sum of the motor vehicle exemption, the aggregate amount of all liens and encumbrances on the vehicle, and the amount necessary to repay the judgment creditor for fees and costs advanced to the levying officer. Absent such a bid, the sheriff must return the automobile to the debtor. *Id.* § 690.2(b)-(d).

be able to force a sale or fund a bid at a forced sale.<sup>24</sup>

Through judicious and good faith use of debtor protections from harsh collection tactics and protections against or limitations on execution to enforce a judgment, the debtor may be able to gain valuable time to overcome temporary financial distress.

### *Defenses or Counterclaims*

In some cases, financial distress for the individual consumer debtor may be caused by one or a few large debts. In such cases especially, it is appropriate for the attorney to explore with the client any possible defenses to payment of the obligation, or possible counterclaims which the debtor could assert and use as leverage to negotiate a settlement.

In addition to the statute of limitations, and traditional contract or fraud defenses, federal and state consumer protection legislation of the past two decades is a wellspring for defenses or claims. Debtors derive substantial and far reaching pro-

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24. The judgment creditor may obtain a lien on such property by recording an abstract of judgment with the county recorder of the county in which the real property is located, unless the debtor has previously recorded a valid declaration of homestead with respect to such property. *Id.* § 674. *Swearingen v. Byrne*, 67 Cal. App. 3d 580, 136 Cal. Rptr. 736 (1977). If a valid declaration of homestead has been filed, a lien on the property may only be obtained by seeking forced sale of the property. CAL. CIV. CODE § 1245 (West 1954). A sale is not possible unless the fair market value of the residence exceeds the sum of the debtor's exemption and all liens and encumbrances on the property. *Id.* § 1255. If a sale would be possible, the judgment creditor would cause the sheriff to levy writ of execution upon the property (thus creating the lien, *id.* § 1245) and follow levy of the writ by timely application for appointment of appraisers. *Id.* §§ 1245-1252. CAL. CIV. PROC. CODE § 690.31 (West Supp. 1979) mandates different procedures for the forced sale of residential property which is not protected by a declaration of homestead but which is nevertheless protected by the claimed residential exemption. *Krause v. Superior Court*, 78 Cal. App. 3d 499, 144 Cal. Rptr. 194 (1978).

Forced sale of homesteaded property requires a bid in cash (or by certified or cashier's check) sufficient to pay at least the amount of the debtor's exemption and all liens and encumbrances on the property and this is probably also true for forced sale of property subject to the claimed residential exemption. CAL. CIV. CODE §§ 1255-1256 (West 1954); CAL. CIV. PROC. CODE § 690.31(a)(1)-.31(j) (West Supp. 1979); *Kelly v. Barnet*, 24 Cal. App. 119, 140 P. 605 (1914). Moreover, the judgment debtor is entitled to redeem the property from sale for twelve months following sale. CAL. CIV. PROC. CODE §§ 700a, 701-702 (West 1954 & Supp. 1979). It is not surprising, therefore, that forced sales of residences are rare.

For a fuller treatment of the nature and relationship of the declared homestead exemption and the claimed residential exemption see Adams, *Homestead Legislation in California*, 9 PAC. L.J. 723 (1978). Revision of this part of California's enforcement of judgment law is also contemplated by the proposal of the CALIFORNIA LAW REVISION COMMISSION. COMM'N TENTATIVE RECOMMENDATION, *supra* note 22, at 66-78.

tection in consumer credit transactions from the federal truth-in-lending, equal credit opportunity, fair credit reporting and fair credit billing legislation.<sup>25</sup> Federal warranty legislation and Federal Trade Commission Rules provide additional protection for consumer debtors.<sup>26</sup> Parallel California consumer credit legislation<sup>27</sup> and legislation governing retail installment sales,<sup>28</sup> warranties,<sup>29</sup> unfair and deceptive practices,<sup>30</sup> and door-to-door

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25. Consumer Credit Cost Disclosure (Truth in Lending) Act, 15 U.S.C. §§ 1601-1667e (1976); Equal Credit Opportunity Act, 15 U.S.C. §§ 1691-1691f (1976); Fair Credit Reporting Act, 15 U.S.C. §§ 1681-1681t (1976); Fair Credit Billing Act, 15 U.S.C. §§ 1666-1666j (1976) (amending the Truth in Lending Act).

26. Magnuson-Moss Warranty - Federal Trade Commission Improvement Act, §§ 101-112, 15 U.S.C. §§ 2301-2312 (1976) (amending sections of the Federal Trade Commission Act, 15 U.S.C. §§ 41-58). See Brickey, *The Magnuson-Moss Act - An Analysis of the Efficacy of Federal Warranty Regulation as a Consumer Protection Tool*, 18 SANTA CLARA L. REV. 73 (1978).

Among the Federal Trade Commission Rules, those which are relevant to the kinds of debts frequently incurred by consumer debtors are: (1) Existing rules governing door-to-door sales, 16 C.F.R. § 429 (1978); negative option plans, *id.* § 425, mail order merchandise, *id.* § 435, and proprietary vocational and home study schools, *id.* § 438 (effective January 1, 1980); (2) proposed rules which would govern credit practices, 40 Fed. Reg. 16,347 (1975) (to be codified in 16 C.F.R. § 444), funeral practices, 40 Fed. Reg. 39,901 (1975) (to be codified in 16 C.F.R. § 453), health spas, 40 Fed. Reg. 34,615 (1975) (to be codified in 16 C.F.R. § 443), hearing aids, 40 Fed. Reg. 26,646 (1975) (to be codified in 16 C.F.R. § 440), insulation, 42 Fed. Reg. 59,678 (1977) (to be codified in 16 C.F.R. § 460), mobile homes, 40 Fed. Reg. 23,334 (1975) (to be codified in 16 C.F.R. § 441), and used motor vehicles, 41 Fed. Reg. 1089 (1976) (to be codified in 16 C.F.R. § 455); (3) possible future proposed rules embodying established principles of consumer protection, 41 Fed. Reg. 3322 (1976).

There may be no private right of action under these trade regulation rules. See *Holloway v. Bristol-Myers Corp.*, 485 F.2d 986 (D.C. Cir. 1973) (private parties have no right of action to enforce provisions of the Federal Trade Commission Act); but see *Guernsey v. Rich Plan of the Midwest*, 408 F. Supp. 582 (N.D. Ind. 1976) (claim for relief stated by private parties to enforce provisions of Act where FTC had previously issued cease-and-desist order against nearly identical deceptive and unfair trade practices of the same defendant). However, violation of those rules would almost certainly be an unfair or deceptive practice in California, entitling the individual to restitutionary relief. CAL. BUS. & PROF. CODE §§ 17200, 17203 (West Supp. 1979); *Chern v. Bank of America*, 15 Cal. 3d 866, 544 P.2d 1310, 127 Cal. Rptr. 110 (1976). This would probably also be true for violations of Federal Trade Commission Rules which implement provisions of the federal consumer warranty legislation noted above, 16 C.F.R. §§ 701-702 (1978) (disclosure and pre-sale availability of written consumer product warranty terms and conditions).

27. Song-Beverly Credit Card Act of 1971, CAL. CIV. CODE §§ 1747-1748.5 (West 1973 & Supp. 1979); Consumer Credit Reporting Agencies Act, CAL. CIV. CODE §§ 1785.1-.35 (West Supp. 1979); The Holden Credit Denial Disclosure Act of 1976, CAL. CIV. CODE §§ 1787.1-.3 (West Supp. 1979); CAL. CIV. CODE §§ 1799.90-.96 (West Supp. 1979) (warnings to guarantors).

28. Unruh Act, CAL. CIV. CODE §§ 1801-1812.10 (West 1973 & Supp. 1979); Automobile Sales Finance Act, CAL. CIV. CODE §§ 2981-2984.4 (West 1974 & Supp. 1979).

29. CAL. COM. CODE §§ 2314-2316, 2719 (West 1964 & Supp. 1979); Song-Beverly Consumer Warranty Act, CAL. CIV. CODE §§ 1790-1797.5 (West 1973 & Supp. 1979).

30. CAL. BUS. & PRO. CODE §§ 17200, 17500 (West 1964 & Supp. 1979).

sales<sup>31</sup> offer protections to consumer debtors which complement or enhance protections under federal law. Moreover, given virtual elimination of the holder-in-due-course doctrine in consumer transactions, defenses and claims will be assertable in some fashion against third party assignees of an original credit seller or lender.<sup>32</sup>

In many instances of insolvency counseling, potential defenses may not be worth asserting because the total amount of debt calls for other insolvency relief, such as liquidation and discharge under bankruptcy law. Expenditure of time and effort on even meritorious defenses or claims is foolish if liquidation is appropriate and will result in discharge of the debt in any event. However, if the amount of potential recovery for any debtor claim against a creditor is large, the client may wish to consider assertion and prosecution of that claim without or prior to filing a petition for liquidation with the hope that substantial recovery might enable the debtor to pay other debts. If the debtor declines this option, the claim will pass to the bankruptcy trustee as an asset of the estate.<sup>33</sup>

### *Recourse to Bankruptcy Law*

Federal bankruptcy law offers the individual consumer debtor the option to seek court supervised and enforced adjustment of debts by way of composition or extension or discharge of indebtedness following liquidation.<sup>34</sup> Adjustment of debts may be advisable if the debtor wishes and is able to pay his or her debts, or some portion of each, and is willing to subject his or her income to court supervision for several months or years. In the event that all other alternatives are unacceptable, liquidation will be advisable if the debtor can exempt all or a substantial portion of his or her assets for a post-bankruptcy fresh start, if the debtor would be entitled to a discharge, and if a substantial portion of the debt is dischargeable.

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31. CAL. CIV. CODE §§ 1689.5-.13 (West Supp. 1979).

32. See, e.g., Warren, *Comments on Vasquez v. Superior Court*, 18 U.C.L.A. L. REV. 1041 (1971); Comment, *The Federal Trade Commission Rule on the Preservation of Consumers' Claims and Defenses - What Price Protection?*, 16 SANTA CLARA L. REV. 815 (1976).

33. The claim will be an asset of the estate under section 541 of title 11 of the Bankruptcy Reform Act of 1978 but may be abandoned under section 554 of title 11 if burdensome or of inconsequential value to the estate. Bankruptcy Reform Act of 1978, 11 U.S.C.A. §§ 541, 554 (West Spec. Pamp. 1979).

34. See text accompanying notes 113-359 *infra*.

Nothing in the new collection conduct, wage garnishment, or bankruptcy legislation affects some of the alternatives outlined here. The legislation is clearly relevant, however, to several of the alternatives: forestalling collection of debt, resisting wage garnishment, and the filing of a petition for adjustment of debts or for liquidation and discharge. It is to those alternatives that the remainder of this article is addressed.

#### FACING DEBT COLLECTORS

Communications between debtor and debt collector, of which there must be thousands each day, frequently offer intense human drama, drama to which the attorney is seldom privy and which therefore is somewhat more difficult for the attorney to appreciate. Imagine for a moment the actors in this drama. The employee of the creditor or collection agency has practiced his part many times and has accumulated a wealth of information and techniques. For that actor the individual debtor may be no more than one person, among hundreds in a caseload, from whom money is to be extracted so that a file can be cleared off the desk and put out of mind as well as out of sight. The individual debtor usually does not act in the drama by choice; more often the role has been thrust upon him by the vagaries of unemployment, illness, disability, or family problems.<sup>35</sup> New to the stage, the individual debtor may know little about what to say or how to respond to the often intense pressure which may be brought to bear upon him to pay his obligations. In some cases, the debt collector acts humanely, with sympathy and patience and in the spirit of cooperation. In other cases, the debt collector acts inhumanely, with discourtesy and belligerence and in a spirit approaching extortion.<sup>36</sup>

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35. D. CAPLOVITZ, *CONSUMERS IN TROUBLE: A STUDY OF DEBTORS IN DEFAULT* 57-76 (1974).

36. In September, 1977, Congress enacted the Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692-1692o (Supp. 1977) to remedy widespread abuses by third party debt collectors. The legislative history noted many forms of abuse, including obscene or profane language, threats of violence, telephone calls at unreasonable hours, misrepresentation of a consumer's legal rights, disclosure of a consumer's personal affairs to friends, neighbors, or an employer, obtaining information about a consumer through false pretense, impersonating public officials and attorneys, and simulating legal process. S. REP. No. 382, 95th Cong., 1st Sess. 1, reprinted in [1977] U.S. CODE CONG. & AD. NEWS 1695; see NAT'L COMM'N ON CONSUMER FINANCE, *CONSUMER CREDIT IN THE UNITED STATES* 42 (1972) (recommendations of Comm'n); *Resort to the Legal Process in Collecting Debts from High Risk Credit Buyers in Los Angeles - Alternative Methods for Allocating Present Costs*, 14 U.C.L.A. L. REV. 879, 896-901 (1967).

For its participants, especially for debtors, acting in the drama can be a distasteful and upsetting personal experience.

The insolvency counselor can play an important role in this drama, more so in the 1980's than before because of recent legislation increasing the protections of debtors against harassing, abusive, unfair, or simply annoying collection efforts. The insolvency counselor may need to do nothing more than provide information enabling the debtor to communicate and negotiate more effectively with debt collectors. More may be required where the debtor continues to feel incapable of dealing with a debt collector or where the client would be entitled to assert, by way of defense or counterclaim, prior unlawful collection practices as a basis for negotiating a settlement of the debt collector's claim for payment.

Liability in tort—for invasion of privacy, or defamation, or intentional infliction of emotional distress—is generally insufficient to control collection practices because individual elements of a cause of action are difficult to prove and because the debtor subject to collection is typically the least capable of affording legal representation.<sup>37</sup> The difficulty of proof and the often limited amount of potential damages will deter many attorneys from representing clients for a contingency fee.

Legislation of the late 1970's reaches beyond traditional tort theories to constrain collection practices. In 1977, Congress enacted the Fair Debt Collection Practices Act<sup>38</sup> to govern the conduct of collection agencies but not the conduct of creditors collecting debts on their own behalf.<sup>39</sup> In the same year, California enacted the Robbins-Rosenthal Fair Debt Collection Practices Act<sup>40</sup> which governs the conduct of debt collectors gener-

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37. For an analysis of tort remedies for unreasonable collection practices, see Shienfeld, *Current Trends in the Restriction of Creditors' Collection Activities*, 9 HOUS. L. REV. 615, 628-33 (1972); Hurt, *Debt Collection Torts*, 67 W. VA. L. REV. 201 (1965); Comment, *Effectively Regulating Extrajudicial Collection of Debts*, 20 ME. L. REV. 261 (1968).

38. 15 U.S.C. §§ 1692-1692o (Supp. I 1977).

39. The definition of "debt collector" in the federal legislation clearly excludes creditors collecting debts on their own behalf and also excludes certain persons or entities, such as attorneys and consumer credit counseling services, who collect debts on behalf of others. *Id.* § 1692a(6). In a recent report to Congress, the Federal Trade Commission urged Congress to broaden the scope of the Fair Debt Collection Practices Act to govern the conduct of all persons seeking to collect debt because of widespread abuses noted in the collection conduct of persons other than debt collectors. FEDERAL TRADE COMMISSION, FAIR DEBT COLLECTION PRACTICES—1979 ANNUAL REPORT TO CONGRESS (Mar. 20, 1979) reprinted in [1974] CONSUMER CREDIT GUIDE (CCH) No. 557, pt. Z, at 6-7.

40. CAL. CIV. CODE §§ 1788-1788.32 (West Supp. 1979).

ally, not just collection agencies,<sup>41</sup> and which also imposes specific obligations upon debtors.<sup>42</sup> In California, collection agencies are also governed by the Business and Professions Code which mandates a licensing system administered by the Bureau of Collection and Investigative Services of the Department of Consumer Affairs.<sup>43</sup> While provisions of the Business and Professions Code and administrative regulations of the Bureau<sup>44</sup> constitute an independent source of debtor protection, they are discussed only in passing here because the more recent federal and state legislation in general provide greater protection for debtors.<sup>45</sup>

Both the federal and California law governing collection conduct are relatively straightforward and easy to understand. Both begin with statements of finding and purpose and continue with definitions which serve to delineate the scope of their coverage.<sup>46</sup> Through definitions of the word "debt", "creditor", and "consumer", both laws limit their protections to the individual consumer debtor whose debt arose in a transaction concerning money, property or services acquired primarily for personal, family or household use.<sup>47</sup>

Each law lists specific collection practices which are pro-

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41. In the California legislation, the term "debt collector" means "any person who, in the ordinary course of business, regularly, *on behalf of himself or others*, engages in debt collection." *Id.* § 1788.2(c) (emphasis added).

42. The obligations imposed upon debtors include refraining from applying for credit when there is no reasonable probability of being able, or no intention, to repay an obligation, refraining from submitting false or inaccurate information in seeking credit, refraining from using credit privileges which have been terminated or suspended, notifying a creditor of an unauthorized use of an account, and notifying the creditor of a debtor's change of name, address, or employment. *Id.* §§ 1788.20, 1788.22. Some of these obligations are conditioned upon the creditor disclosing such obligations to the debtor clearly and conspicuously in writing. *Id.*

43. CAL. BUS. & PROF. CODE §§ 6863-6956 (West 1975 & Supp. 1979).

44. CAL. ADMIN. CODE tit. 16, §§ 606-641 (1978), promulgated under the authority granted in CAL. BUS. & PROF. CODE § 6863 (West Supp. 1979).

45. CAL. BUS. & PROF. CODE § 6947.1 (West Supp. 1979) imposes civil liability upon a collection agency that engages in conduct which violates the provisions of section 6947. Among other things, section 6947 prohibits any unfair or misleading practices and resort to any illegal means or methods of collection. *Id.* § 6947. CAL. ADMIN. CODE tit. 16, § 627 (1978) lists certain practices, including some practices to be discussed in the text, which could be termed unfair, misleading or illegal within the meaning of section 6947. In actions maintained under section 6947.1, the prevailing party is entitled to an award of reasonable attorney's fees. CAL. BUS. & PROF. CODE § 6947.1(c) (West Supp. 1979).

46. 15 U.S.C. §§ 1692, 1692a (Supp. I 1977); CAL. CIV. CODE §§ 1788.1-.2 (West Supp. 1979).

47. 15 U.S.C. § 1692a(3)-(5) (Supp. I 1977); CAL. CIV. CODE § 1788.2(d)-(e), (i) (West Supp. 1979).



hibited, provides for consumer redress through civil liability and, in the case of the federal legislation, provides for enforcement by administrative agencies. No very useful purpose would be served by repeating the lists of prohibited practices here. It does seem appropriate, however, to highlight and compare some of the more significant proscriptions of each law and to consider the effectiveness of the prescribed remedies. As this comparison proceeds, bear in mind one important distinction: if the debt collector is a collection agency, its conduct must be measured by the highest standard of debtor protection which can be derived by reading both the federal and California laws together, because the federal law preempts any state law (concerning collection agencies) that is less protective of debtors than the federal law and defers to any state law that is more protective of debtors.<sup>48</sup> If, however, the debt collector is not a collection agency, the debt collector's conduct may be measured only by reference to the California law (as well as by reference to principles of tort) because the federal law does not (yet) apply to debt collectors that are not collection agencies.

#### *Communication with the Debtor*

Both laws prohibit communications with the debtor which are harassing, or abusive, or inconvenient. Obscene or profane language, threats of violence to person or reputation or property, and telephone calls at midnight or with unrelenting frequency are among the kinds of conduct which are prohibited.<sup>49</sup> Both laws go further, however. Under the federal law, the debt collector may not communicate in any way with the debtor if the debt collector knows that the debtor is represented by an attorney with respect to the debt in question and has knowledge of, or can readily ascertain, the name and address of the attorney, unless the attorney fails to respond to communications within a reasonable time or unless the attorney consents to communication with the debtor.<sup>50</sup> The California law contains a similar prohibition which is further conditioned upon a *written* notification from the attorney to the debt collector stating that the debtor is represented by the attorney and requesting that further communications with the debtor cease.<sup>51</sup> This

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48. 15 U.S.C. § 1692n (Supp. I 1977).

49. *Id.* §§ 1692c(a)(1), 1692d; CAL. CIV. CODE §§ 1788.10-.11 (West Supp. 1979).

50. 15 U.S.C. § 1692c(a)(2) (Supp. I 1977).

51. CAL. CIV. CODE § 1788.14(c) (West Supp. 1979).

power is obviously potent because it enables the attorney to offer immediate respite to the debtor who is overwrought from persistent collection efforts. However, redirecting communication to the attorney may ultimately prove costly to the client or harassing to the attorney if the debt collector persists in frequent communications.<sup>52</sup>

The federal law also allows the unrepresented consumer debtor to demand that communication from debt collectors cease. The individual debtor may insist that all but limited types of communication terminate simply by giving the debt collector written notification of the debtor's refusal to pay a debt (a refusal which need not be explained) or of the debtor's desire that communication cease.<sup>53</sup> This request can also originate from the spouse or parent of the debtor as well as from the debtor.<sup>54</sup> There is no similar power granted the debtor under the California law and therefore this valuable tool of debtor protection is available only to restrain the conduct of collection agencies. Finally, the federal law, but not the California law, prohibits the debt collector from communicating with the debtor at the debtor's place of employment if the debt collector knows or has reason to know that the employer forbids such contact with its employees.<sup>55</sup>

### *Communication with Third Parties*

Debt collectors are aware that communication with persons other than the debtor concerning a debtor's delinquency in payment is potentially embarrassing to or disruptive for the debtor. Accordingly, debt collection practice has included communication about the debtor's delinquency or the consequences of continued delinquency with the debtor's employer or fellow employees, with members of the debtor's family, or with friends or neighbors of the debtor with the expectation

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52. It should be noted, however, that the attorney to whom communications are to be directed would also be protected against harassment because both the federal and California law prohibit debt collectors from engaging in conduct that will harass, abuse, or oppress any person. 15 U.S.C. § 1692d (Supp. I 1977); CAL. CIV. CODE § 1788.11 (West Supp. 1979). Accordingly, it would appear that a debt collector who must restrict communications to the attorney may not communicate with the debtor on the grounds that an attorney has failed to respond to the debt collector's communications if the lack of attorney response is attributable to harassing conduct by the collection agency.

53. 15 U.S.C. § 1692c(c) (Supp. I 1977).

54. *Id.* § 1692c(d).

55. *Id.* § 1692c(a)(3).

that this communication will pressure a debtor to pay.<sup>56</sup> Both laws severely restrict this practice.

Under the federal law, a debt collector may not communicate at all with an employer except for the purpose of acquiring or confirming location information concerning the debtor or except as is necessary to effectuate a post judgment judicial remedy.<sup>57</sup> Communication to acquire location information is carefully circumscribed: there can be no mention that a debt is owing, no communication by post card, no written communication which in any way suggests that the inquirer is a debt collector or that the inquiry relates to the collection of a debt, and, generally, only one such communication is allowed.<sup>58</sup> The provisions of the California law governing contact with the debtor's employer are similar.<sup>59</sup>

The federal law permits the debt collector to seek location information from persons or entities other than the debtor's employer but otherwise prohibits any communication with all but a few specified third parties.<sup>60</sup> The California law appears to be somewhat less restrictive in this respect because it does not explicitly prohibit communication regarding a debt with friends or neighbors of the debtor.<sup>61</sup>

### *Threats to Initiate Legal Action*

As one would expect, both the federal and California law prohibit the debt collector from threatening action which is not lawful, including a threat of arrest and imprisonment for non-payment of debts, or the threat to dispossess the debtor of property which is not subject to an enforceable security interest or which is exempt from execution.<sup>62</sup> But one might not expect the further protection afforded by both laws through their prohibition of threats to undertake even appropriate legal action,

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56. For an example of this kind of lender pressure, see Homburger, *Harassment of Borrowers by Licensed Lenders*, 1 COLUM. J. L. & SOC. PROB. 39 (1965).

57. 15 U.S.C. §§ 1692b, 1692c(b) (Supp. I 1977).

58. *Id.* § 1692b.

59. CAL. CIV. CODE § 1788.12(a) (West Supp. 1979).

60. 15 U.S.C. § 1692c(b) (Supp. I 1977).

61. CAL. CIV. CODE § 1788.12(b) (West Supp. 1979) prohibits a debt collector from communicating information regarding a consumer debt to any but a few specified persons in the debtor's family. From this prohibition a court might imply that such communication with friends or neighbors would also be prohibited, but there is nothing expressly stated in the statutory language to that effect.

62. 15 U.S.C. §§ 1692d(1), 1692e(4)-(5), 1692f(6) (Supp. I 1977); CAL. CIV. CODE § 1788.10(a),(e)-(f) (West Supp. 1979).

such as repossession of collateral subject to a security interest or suit followed by judgment and garnishment of wages, unless the debt collector has a present intention to undertake such legal action.<sup>63</sup> Regulations of the Bureau of Collection and Investigative Services of the California Department of Consumer Affairs provide useful guidance to help determine if a debt collector entertains a present intention to initiate legal action. Under these regulations, a threat to undertake legal action will constitute an unfair or misleading practice if the debt collector does not entertain a present intention to initiate legal action in the form, manner, or time limit represented to the debtor. That intention may be established or disproved by discovering whether the amount of the claim is within the customary range that has in the past resulted in the licensee (collection agency) initiating legal action on that amount alone, or when that amount is cumulated with other claims.<sup>64</sup> These regulations do not apply to debt collectors other than collection agencies,<sup>65</sup> but they offer useful guidelines for measuring the intention of any debt collector to initiate legal action and might successfully be urged as such in negotiations or in litigation.

#### *Other Unfair Practices*

Both the federal and California law list and prohibit a variety of other practices, including false and misleading representations, which have characterized past collection practices. Use or the threat of use of "deadbeat lists," the threat that assignment of a debt will cut off defenses, the collection of or the threat to collect unauthorized charges, the use of documents that simulate court or governmental agency documents, and suits initiated in courts where venue is improper are among the practices prohibited.<sup>66</sup> In addition, the federal law requires that a debt collector provide the debtor with certain information concerning a debt at the time of or within five days of initial communication with the debtor.<sup>67</sup> This information

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63. 15 U.S.C. § 1692e(4)-(5) (Supp. I 1977); CAL. CIV. CODE §§ 1788.10(e), 1788.13(k) (West Supp. 1979).

64. CAL. ADMIN. CODE tit. 16, § 627(g) (1978).

65. See notes 43-44 and accompanying text *supra*.

66. 15 U.S.C. §§ 1692d(3), 1692e(6), 1692e(9), 1692f(1), 1692i (Supp. I 1977); CAL. CIV. CODE §§ 1788.10(d), 1788.12(c), 1788.13(e), 1788.14(b), 1788.15 (West Supp. 1979).

67. 15 U.S.C. § 1692g(a) (Supp. I 1979). The written notice must contain five items: the amount of the debt; the name of the creditor; a statement that unless the

must include a statement to the debtor of the debtor's right to demand verification of the debt by the debt collector in those cases in which the debt is disputed.<sup>68</sup>

### *Civil Liability*

Enforcement of this array of restrictions upon collection conduct will fall primarily to the individual consumer debtor. While the federal law may be enforced through administrative action by the Federal Trade Commission<sup>69</sup> and although both the federal and California law may be enforced by California's public prosecutors,<sup>70</sup> the resources of those agencies are limited and demands upon their time are great. Under the civil liability provisions of both laws the individual consumer debtor may initiate legal action to recover actual damages and civil penalties and may recover costs and attorney's fees in appropriate cases.<sup>71</sup> The debt collector will not be liable, however, if an

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debtor disputes the validity of the debt, or any portion of it, within 30 days of the receipt of the notice, it will be assumed valid by the debt collector; a statement that if the debtor does dispute the validity of the debt, the collector will mail a copy of the judgment or verification of the debt to the debtor; and a statement that the collector will provide the debtor with the name and address of the original creditor (if different from the current creditor) upon the debtor's written request within the 30 day period. *Id.* § 1692g(a)(1)-(5).

68. *Id.* § 1692g(a)(4). If the debtor demands verification of the debt within the 30 day period by giving notice that the debt is disputed, or requests the identity of the original creditor, section 1692g(b) provides that the debt collector "shall cease collection of the debt, or any disputed portion thereof" until the collector mails the debtor the verification, copy of judgment and/or name and address of the original creditor. *Id.* § 1692g(b).

69. Administrative enforcement of the Fair Debt Collection Practices Act is entrusted generally to the Federal Trade Commission, with enforcement by other federal agencies as specified in section 1692i(b). *Id.* § 1692i(a)-(b). *In Re Trans World Accounts*, 90 FTC 350 (1977), is an example of F.T.C. administrative enforcement concerning debt collection practices. The complaint in that case was issued prior to enactment of the Fair Debt Collection Practices Act under the general authority of the Federal Trade Commission to prohibit unfair and deceptive acts or practices in commerce. 15 U.S.C. § 45 (1952). Such a complaint would now probably be issued under the authority of the Fair Debt Collection Practices Act.

70. Violation of the Fair Debt Collection Practices Act or of the Robbins-Rosenthal Fair Debt Collection Practices Act would no doubt amount to an unfair or deceptive practice within the meaning of CAL. BUS. & PROF. CODE § 17200 (West Supp. 1979). The state attorney general, district attorneys, and certain city attorneys are authorized to seek injunctive relief and civil penalties for violation of section 17200. *Id.* §§ 17204, 17206.

71. 15 U.S.C. § 1692k (Supp. I 1977); CAL. CIV. CODE § 1788.30 (West Supp. 1979). There are some significant differences between the civil liability provisions of the two laws. The federal law permits but the California law prohibits class actions. Actual damages are allowable under both laws, but penalties of not less than \$100 nor more than \$1,000 are allowed under the California law only upon proof of wilful and

action is not timely brought,<sup>72</sup> or if the debt collector can prove by a preponderance of evidence that a violation was unintentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid such errors,<sup>73</sup> or if the violation was attributable to good faith compliance by the debt collector with an advisory opinion of the Federal Trade Commission.<sup>74</sup> Moreover, if the debt collector is not a collection agency it may not be held liable under the California law if it timely cures a violation that is capable of being cured<sup>75</sup> or if the debtor has failed to comply with certain obligations imposed upon debtors by California law.<sup>76</sup>

Armed with the threat of civil liability, the debtor or debtor's attorney can insist that undesired extra-judicial collection efforts are curtailed or terminated and, if violations have already occurred, use the threat of liability to bargain more effectively for reduction in amounts payable or for an extension of time in which to pay.

The recent legislation governing the conduct of debt collectors provides a valuable tool in insolvency counseling. Recourse to it can at least bring the insolvent debtor some relief from the emotional turmoil often attendant to facing debt collectors. It may also provide the debtor with additional time to restore balance to financial affairs. Of course, nothing in the legislation prohibits a debt collector from initiating legal action to collect a debt, including garnishment of wages following

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knowing violation, whereas penalties in an individual action not exceeding \$1,000 are allowable under the federal law even though unintentional.

72. Both laws establish a one year statute of limitations running from the date on which the violation occurs. 15 U.S.C. § 1692k(d) (Supp. I 1977); CAL. CIV. CODE § 1788(f) (West Supp. 1979).

73. 15 U.S.C. § 1692k(c) (Supp. I 1979); CAL. CIV. CODE § 1788.30(f) (West Supp. 1979). This defense derives from the identical defense first introduced in connection with federal truth in lending legislation, Consumer Credit Cost Disclosure (Truth in Lending) Act, § 130(c), 15 U.S.C.A. § 1640(c) (West 1974 & Supp. 1979). The defense has been narrowly construed to apply mainly to clerical errors. See, e.g., *Ratner v. Chemical Bank New York Trust Co.*, 329 F. Supp. 270, 281 (S.D.N.Y. 1971).

74. 15 U.S.C. § 1692k(e) (Supp. I 1977).

75. CAL. CIV. CODE § 1788.30(d) (West Supp. 1979). The statute gives no guidance on the question of which violations are capable of being cured, or how a violation could be cured. One could easily imagine a debt collector curing the violation arising from the false representation that assignment of the debt would cut off defenses by informing the debtor to the contrary. But could the violation consisting of the use of obscene language, or the threat to use violence, or any number of other actions truly be cured? Would an apology suffice as a cure?

76. *Id.* § 1788.30(g). The debtor's obligations are mentioned in note 42 *supra*.

judgment. Thus, invoking protection against wage garnishment is another important aspect of relief from insolvency.

WAGE GARNISHMENT UNDER THE EMPLOYEES' EARNINGS  
PROTECTION LAW OF 1978

As previously suggested, it may be desirable to suggest that an individual consumer debtor attempt to forestall collection efforts.<sup>77</sup> A clear potential consequence of this approach for the wage earning debtor is the possibility that a creditor or several creditors will reduce their claims to judgment and seek to satisfy the judgment(s) by means of wage garnishment. The wait-and-see stance may be more or less desirable depending upon the ability of the debtor to live with, impede, or defeat the use of this remedy. It is therefore essential that the insolvency counselor be fully conversant with the law governing wage garnishment.

California's existing wage garnishment law,<sup>78</sup> superceded by the Employees' Earnings Protection Law, effective January 1, 1980,<sup>79</sup> is familiar to many. It has been discussed and criticized fully in the existing literature.<sup>80</sup> Less well known, perhaps, have been the continuing efforts of the California Law Revision Commission to induce reform of wage garnishment law in ways which the Commission perceived to be beneficial in some respects to all parties concerned: debtors, creditors and employers.<sup>81</sup> The Commission's recommendations, appearing first in proposed legislative form in 1972,<sup>82</sup> were tossed about for seven years.<sup>83</sup> Persistent efforts by the Commission to

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77. See text accompanying notes 19-24 *supra*.

78. Basic provisions governing wage garnishment until the effective date of the Employees' Earnings Protection Law are found at CAL. CIV. PROC. CODE §§ 682.3, 690.6, .50 (West Supp. 1979).

79. *Id.* §§ 723.010 - .154 (added by 1978 Cal. Stats. ch. 1133, § 7, at 3796). At the request of the Judicial Council and California Law Revision Commission, the original effective date of the law (July 1, 1979) was delayed to provide the Judicial Council with more time to prepare mandatory forms required by the law. 1979 Cal. Stats. ch. 66, § 5.

80. See, e.g., Comment, *Wage Garnishment: Still Driving the Wage-Earning Family to the Wall*, 17 SANTA CLARA L. REV. 631 (1977).

81. The Commission was charged by Resolution Chapter 202 of the Statutes of 1957 and by Resolution Chapter 45 of the Statutes of 1974 to include study of wage garnishment in their work. *Recommendation Relating to Wage Garnishment Exemptions*, 12 CAL. L. REVISION COMM'N REP. 903 (1974).

82. S.B. 88, 1972 Reg. Sess. (1972).

83. Bills encompassing Commission recommendations for wage garnishment reform were defeated or died in the 1972 Regular Session, the 1974 Regular Session and

achieve significant reform have been consistently opposed and frustrated by creditor interests. As a consequence, the Employees' Earnings Protection Law, though impressive in its length and detailed treatment of specific garnishment issues, is only slightly more than a shadow of the important substantive reforms urged so long by the Commission.

The Employees' Earnings Protection Law does include some important reform in procedure, in garnishment to collect state taxes, and in garnishment to collect delinquent alimony and child support obligations. Save for some discussion of the procedure by which a debtor is to claim an exemption of wages from garnishment, I shall leave explanation and analysis of these reforms to others. Prior to that discussion, however, I wish to comment upon those of the Commission reforms which were not enacted because, from my perspective, they were the most important and because they would most dramatically alter wage garnishment (and hence insolvency counseling) if enacted by piecemeal amendment to the Employees' Earnings Protection Law in the 1980's. My comments are also intended to urge these reforms.

#### *Absence of Debtor Protection Reform*

The important Commission reform proposals which were excised from the final legislation related to the *amount* of wages which could be garnished by creditors. Since 1968, the amount which could be garnished was determined by a rather curious statutory route. Section 690.6(a) of the California Code of Civil Procedure (hereafter C.C.P.) exempted from (post judgment) execution "[o]ne-half or such greater portion as is allowed by statute of the United States" of earnings of the debtor received for services rendered within the thirty days preceding the date of a withholding.<sup>84</sup> That portion of the language quoted which protected "one-half" of the debtor's earnings was superfluous (for the most part) since the enactment in 1968 of the Con-

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the 1976 Regular Session. The Employees' Earnings Protection Law discussed in the text was introduced by Assemblyman McAlister as A.B. 393, 1977-78 Reg. Sess. (1978). It was introduced on February 3, 1977, amended in the Assembly on March 21, 1977, amended in the Senate on April 27 and June 14, 1977, subsequently referred to Conference Committee and carried over to 1978 as a two-year bill and finally enacted, after further amendment, near the close of the 1978 Regular Session on August 31, 1978. The governor signed the legislation on September 25, 1978. CALIFORNIA ASSEMBLY INTERIM HISTORY, 1977-78, Reg. Sess. 14 (1978).

84. CAL. CIV. PROC. CODE § 690.6(a) (West Supp. 1979).



sumer Credit Protection Act,<sup>85</sup> a "statute of the United States," under which at least seventy-five percent of a debtor's "disposable earnings" are exempted from garnishment (except in specified cases).<sup>86</sup> The route did not end there, however, for returning to C.C.P. section 690.6(b), one found that more than seventy-five per cent and conceivably *all* of the debtor's earnings could be exempted from garnishment if the debtor could establish, in a claim of exemption proceeding under C.C.P. section 690.50, that all of the debtor's earnings were necessary for the support of the debtor or the debtor's family. However, this "hardship exemption" was not available where the garnishing creditor was seeking to collect a judgment debt incurred by the debtor (or the debtor's spouse or family) for the common necessities of life such as food, clothing, shelter or medical care.<sup>87</sup> In such cases, the debtor could only protect seventy-five percent of disposable earnings even though the debtor could conclusively demonstrate the absolute necessity to devote all earnings to his or her current support or the support of family.

The Commission saw at least four basic problems with this scheme. First, because of the definition of "disposable earnings" in the federal garnishment legislation, debtors with large families were afforded no more protection than debtors with small families or with no dependents at all. Despite the number of dependents, the debtor's take-home pay was roughly the same. Second, low income debtors were provided inadequate protection because the minimum amount protected from any wage garnishment under the federal scheme was and is not sufficient to maintain a minimum adequate standard of living. Third, the common necessities exception to the hardship exemption was perceived as harsh to necessitous debtors and as arbitrarily preferring some creditors to others. Finally, the judicially evolved doctrine for measuring hardship, which referred to the debtor's accustomed standard of living or a standard of living appropriate to the debtor's station in life, was viewed as unfair to creditors.

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85. Consumer Credit Protection Act, §§ 301-307, 15 U.S.C. §§ 1671-1677 (1976 & Supp. I 1977).

86. *Id.* § 303(a), 15 U.S.C. § 1673(a) (1976). Greater protection from garnishment is offered by the Consumer Credit Protection Act to low income debtors. *Id.* Garnishment to enforce obligations for support or federal or state taxes are treated separately. *Id.* § 303(b)(1)-(2), 15 U.S.C. § 1673(b)(1)-(2) (Supp. I 1977); I.R.C. § 6334(a)(8)-(9); CAL. CIV. PROC. CODE §§ 723.031, .052, .074, .076 (West Supp. 1979).

87. CAL. CIV. PROC. CODE § 690.6(b)(1) (West Supp. 1979).

*Unfair treatment of debtors with dependents*

Though no doubt unintended, the federal formula for wage garnishment gives no more protection to wage earners with large families than it does to wage earners who are single. This anomalous result was described by the Law Revision Commission:

For example, if the employee whose wages are garnished has gross weekly earnings of \$100, approximately \$6.25 is withheld [i.e. garnished] if he is single, \$15.79 if he is married and has two children, and \$20.69 if he is married and has six children. The employee's take-home pay after garnishment will be \$69 for the week, whether he is single or is married with two or with six children. This strange result occurs because garnishment under federal law is calculated on disposable earnings, and disposable earnings increase as the number of income tax exemptions for dependents increases.<sup>88</sup>

A garnishment formula which leaves more take-home pay for debtors with dependents than for debtors without or with fewer dependents would be more rational. The Law Revision Commission proposed such a formula and compromised it at least twice in an attempt to gain legislative approval,<sup>89</sup> but in

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88. *Recommendation Relating to Wage Garnishment Procedure*, 13 CAL. L. REVISION COMM'N REP. 621-22 (1975).

89. The Commission's original proposal would have avoided the anomaly described in the text accompanying note 88 *supra* by computing the amount which could be garnished on the basis of "available earnings" (rather than disposable earnings). *Recommendation Relating to Wage Garnishment Exemptions*, 12 CAL. L. REVISION COMM'N REP. 916 (1974). Available earnings for a workweek were defined as all earnings for the workweek less the sum of the following: 1) the amount that would be withheld for federal personal income taxes from the same amount of earnings of a single person who claims no exemptions; 2) a prescribed amount for social security taxes; 3) a prescribed amount for worker contributions to the Unemployment Compensation Disability Fund; 4) the amount that would be withheld for state personal income taxes from the same amount of earnings of a single person who claims no exemptions; 5) thirty times the federal minimum wage. *Id.* at 922. For purposes of garnishment, this definition effectively treated a person with several dependents as if he or she were a single person. In this way, garnishment of wages of all persons, with or without dependents, would be identical, but the debtor with dependents would be taking home a larger paycheck because of lower income tax withholding.

The Commission's proposal specified that no wages were to be garnished if available earnings per workweek were less than \$10, that 50 percent of available earnings per workweek were to be garnished if such earnings amounted to not less than \$10 and not more than \$45, and that \$23 plus 25 percent of available earnings in excess of \$45 were to be garnished if available earnings per workweek exceeded \$45. *Id.*

While this formula was complicated, it was to be implemented by tables to be

the end the legislature refused to change the existing scheme because of creditor opposition which sought to preserve to creditors the ability to garnish as much money as possible. Because excessive garnishment may drive an employee to welfare or into bankruptcy, creditor opposition to this aspect of garnishment reform may disserve the aggregate best interests of creditors.

*Inadequate protection for low income debtors*

Under the federal garnishment formula, debtors whose weekly disposable earnings do not exceed thirty times the minimum wage are completely insulated from wage garnishment.<sup>90</sup> While the minimum wage has increased,<sup>91</sup> the resulting minimum protected earnings are simply not enough to sustain even the most meager standard of living given current rates of inflation,<sup>92</sup> especially for debtors with dependents. Consider, for example, the case of a debtor, married and with one small

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prepared by the Judicial Council for use by employers who could simply consult the tables to determine the proper amount to be withheld. Given such ease of application, the complexity of the formula was amply justified by the fairness of the result generated.

The Commission considered but rejected a proposed amendment to its formula offered in 1976 by the Debtor/Creditor and Bankruptcy Committee of the State Bar. COMM. ON RELATIONS OF DEBTOR AND CREDITOR, STATE BAR OF CAL., REPORT ON CALIFORNIA LAW REVISION COMMISSION RECOMMENDATION RELATING TO WAGE GARNISHMENT PROCEDURES (July 9, 1976) [hereinafter BAR COMM. REPORT]. That amendment would have altered the definition of available earnings to reflect regular paycheck deductions for health insurance and to reflect higher costs of living. *Id.* at 6 app. B. The proposed amendment would have reduced the amount of available earnings for all debtors and thus reduced the amount of garnished funds from all debtors in the aggregate. The Commission's rejection of the amendment on the ground, among others, that it would draw heavy creditor opposition only too well anticipated the opposition to be successfully mounted against the Commission's own more modest formula.

Because the Commission's proposal extended greater protections to debtors, creditor opposition surfaced. The Commission twice suggested compromise during the 1977-78 Regular Session. The compromise solutions proposed a return to the basic federal garnishment formula with the additional provision that the amount to be garnished under such formula would be reduced by "dependency allowances". The first proposed compromise suggested a \$5 per dependent allowance and the subsequent proposed compromise suggested a \$3 per dependent allowance. All attempts at compromise failed, however, and the legislature preserved the present garnishment formula intact in the Employees' Earnings Protection Law, CAL. CIV. PROC. CODE §§ 723.050-.051 (West Supp. 1979)(operative January 1, 1980).

Some of the information provided above is drawn from memoranda of the Commission and of the State Bar Debtor/Creditor and Bankruptcy Committee (on file at Santa Clara Law Review).

90. Consumer Credit Protection Act, § 303(a), 15 U.S.C. § 1673(a) (1976).

91. 29 U.S.C. § 206(a)(1) (Supp. I 1977).

92. *Recommendation Relating to Wage Garnishment Exemptions*, 12 CAL. L. REVISION COMM'N REP. 913-14, 914 n.16 (1974).

child, whose weekly disposable earnings equal thirty times the 1979 minimum wage ( $30 \times \$2.90 = \$87.00$ ). Under the federal garnishment formula, any raise of disposable earnings which the debtor received, up to \$116.00, would be taken in its entirety by a garnishing creditor unless the debtor could qualify for the California hardship exemption.<sup>93</sup> To deny the debtor the benefit of any of that raise, when his *current monthly* expenses must frequently overrun disposable monthly income (\$348.00) seems very harsh. The Commission's attempt to remedy this problem was also frustrated.<sup>94</sup>

*The common necessities exception to the hardship exemption*

If a garnishing creditor is seeking to enforce a judgment for a debt incurred for past provision to the debtor of medical care, food, or clothing, the California hardship exemption is unavailable to the debtor. Thus, the California garnishment statute prefers creditors who have extended credit to debtors for the common necessities of life.<sup>95</sup> While this preference has a surface plausibility, its primary justification has never been empirically demonstrated and its impact upon hard pressed debtors is unconscionable.

The primary justification for the common necessities exception appears to be the claim that by assuring "common necessities creditors" some garnishment in any event they will thereby be induced to extend credit more readily for goods or services essential to living.<sup>96</sup> Yet there is no evidence that such

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93. Consumer Credit Protection Act, § 303(a), 15 U.S.C. § 1673(a) (1976); CAL. CIV. PROC. CODE §§ 723.050-.051 (West Supp. 1979)(operative January 1, 1980).

94. The Commission's attempt to extend greater protection to all lower income debtors was encompassed in its proposal to preclude all garnishment if the debtor's available earnings did not exceed \$10. *Recommendation Relating to Wage Garnishment Procedure*, 13 CAL. L. REVISION COMM'N REP. 659 (1975). See also note 89 *supra*. The proposal of the State Bar Debtor/Creditor and Bankruptcy Committee included a provision which would have extended even greater protection to lower income debtors than the Commission's proposal. The provision would have amended the language "thirty times the federal minimum wage" to read "forty times the minimum wage." BAR COMM. REPORT, *supra* note 89, at 6 app. B.

95. See note 87 and accompanying text *supra*.

96. See Brunn, *Wage Garnishment in California: A Study and Recommendations*, 53 CALIF. L. REV. 1214, 1219 (1965):

The special treatment of debts for "common necessities" is difficult to justify. It can be argued that those who sell essentials should have better means of collecting their debts than companies which extend credit for unessential or luxury purchases. The other side of the picture

creditors are even aware of their preferred position in the garnishment scheme or that, even if aware, their credit policies are affected by their knowledge of the preference. Absent such evidence, the justification for the common necessities exception is purely theoretical or, at best, rests solely upon the paternalistic assertion that common necessities creditors are more deserving of governmental assistance in collecting debts than are other creditors.

Even conceding some justification for the common necessities exception, one cannot ignore the plight of the debtor whose claim to the hardship exemption must be denied because of the exception. To say that a debtor would otherwise qualify for the hardship exemption is to say that the debtor absolutely needs the additional protected wages for current sustenance. Deprivation of the additional protected wages under the common necessities exception is, therefore, a virtual modern day equivalent of debtors' prison. Such deprivation is also short sighted because of the clear potential for driving wage earners from employment to welfare and from eventual possible repayment of the debt to discharge in bankruptcy. Yet the legislature here also refused to enact proposed reform.<sup>97</sup>

*The "station-in-life" standard for hardship*

In view of the successful resistance to debtor protection reforms described above it is curious that one reform to benefit creditors was also rejected in the new legislation. Case law had clearly established the right of the debtor to rest a claim of hardship (in the absence of a common necessities creditor) upon his or her accustomed standard of living or "station in life."<sup>98</sup> Thus, theoretically at least, a debtor accustomed to

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is that the statute puts the prudent (or poor) family that buys only essentials into a worse position than the family that buys nonessential items on credit. For example, a big medical bill could lead to garnishments while a debt resulting from the acquisition of a luxury car might be exempt from execution on wages—at least where the debtor is sophisticated in the use of the exemption provisions.

See Comment, *Attachment and Garnishment in California—In Need of Reform*, 4 U.C.D. L. Rev. 57, 77-79 (1971).

97. The Commission's proposal included repeal of the common necessities exception to the hardship exemption. *Recommendation Relating to Wage Garnishment Exemptions*, 13 CAL. L. REVISION COMM'N REP. 623 (1975).

98. *Ratzlaff v. Portillo*, 14 Cal. App. 3d 1013, 1015, 92 Cal. Rptr. 722, 723 (1971) (dicta); *Perfection Paint Products, Inc. v. Johnson*, 164 Cal. App. 2d 739, 741, 330 P.2d 829, 830-31 (1958); *Diamond v. Brent*, 157 Cal. App. 2d Supp. 857, 859, 320 P.2d 621,

driving two automobiles and living in a penthouse apartment might be entitled to exempt all of his or her earnings from garnishment if needed to make car and apartment lease payments. The same might not be true for the debtor driving a used clunker and living in low cost housing. It seems unfair to extend so much protection to the high living debtor and many courts may, in fact, be influenced by the nature of current expenses in ruling adversely on claims of hardship. Particularly if courts are, *de facto*, ignoring the station-in-life test and certainly because the test is inequitable, it ought to be repudiated. The legislature refused to adopt the Commission's recommendation to do so.<sup>99</sup>

This discussion suggests that the Employees' Earnings Protection Law does very little to earn its magnanimous sounding name. Significant debtor protection reform did not survive the legislative process. Moreover, other reform proposals concerning the procedure for claiming the hardship exemption were never submitted for legislative consideration primarily because of anticipated creditor opposition. Those proposals and the procedure for claiming the hardship exemption are also important concerns of the insolvency counselor and insolvent debtor.

### *The Debtor's Claim of Exemption*

Under the Employees' Earnings Protection Law, following issuance of a writ of execution and application by the judgment creditor to the levying officer for an earnings withholding order, the levying officer is required to serve on the debtor's employer an original and one copy of that order together with instructions for the employer, a form for the employer's return, and a notice to the employee of the issuance of an earnings withholding order.<sup>100</sup> Service of these documents

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622 (App. Dep't Super. Ct. 1957); *Los Angeles Finance Co. v. Flores*, 110 Cal. App. 2d Supp. 850, 856, 243 P.2d 139, 143-44 (App. Dep't Super. Ct. 1952); *Sanker v. Humborg*, 48 Cal. App. 2d 205, 207-08, 119 P.2d 433, 434 (1941).

99. The Commission's proposal included the following language: "Neither the judgment debtor's accustomed standard of living nor a standard of living 'appropriate to his station in life' is a criterion for measuring the judgment debtor's claim for [hardship] exemption. . . ." *Recommendation Relating to Wage Garnishment Procedure*, 13 CAL. L. REVISION COMM'N REP. 662 (1975). The legislature deleted this language. CAL. CIV. PROC. CODE § 723.051 (West Supp. 1979) (operative January 1, 1980).

100. CAL. CIV. PROC. CODE §§ 723.102-103 (West Supp. 1979) (operative January 1, 1980).

upon the employer establishes a "withholding period" which commences on the tenth day following service, by which date the employer must have delivered to the debtor the copy of the earnings withholding order and the notice to the employee.<sup>101</sup> This notice must contain a statement, in a form to be prescribed by the Judicial Council,<sup>102</sup> informing the debtor of the wage garnishment, the right to claim an exemption of additional wages necessary for the support of the debtor or the debtor's family, the availability without charge from the office of the levying officer of a debtor's claim of exemption form and financial statement form, and the procedure for seeking a hearing on a claim of exemption.<sup>103</sup>

The drafters did not require automatic delivery to the debtor (by the levying officer through the employer) of a blank claim of exemption and financial statement form.<sup>104</sup> Such a requirement would have eliminated the necessity for the debtor to initiate contact with the levying officer to obtain those forms, a contact which, for some, may be intimidating or at least inconvenient.<sup>105</sup> By requiring that such blank forms automatically be made available to the debtor, the law might have facilitated the assertion of exemption rights by those entitled to claim them. At the same time, such a requirement might also have encouraged the filing of baseless claims for exemption and would also have entailed some waste of paper and postage. The procedure chosen thus assumes that individual consumer debtors are sufficiently literate and assertive to take the steps

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101. *Id.* §§ 723.022(a), 723.104(a).

102. With the exception of forms used in connection with garnishment for state tax liabilities, all forms used in connection with wage garnishment must be those prescribed by the Judicial Council. *Id.* § 723.120. The general informational requirements for each form are listed at *id.* §§ 723.121 -.128.

103. *Id.* § 723.122.

104. Claim of exemption and financial statement forms are made available without cost from the office of the levying officer. *Id.* § 723.129.

105. If there is only one office in a large urban county, a trip to that office during working hours is inconvenient and may further irritate an employer who may already be irritated by the fact of the garnishment. If the debtor requests that the forms be mailed, any delay in mailing or in mail delivery will delay the debtor's filing of the claim of exemption. The same inconveniences operate for the debtor's filing of the claim of exemption and financial statement. My personal experience from debt counseling informs me that any contact with the court system or law enforcement agencies is laden with anxiety for many debtors. That anxiety springs from a variety of factors, including ignorance, embarrassment about having wages garnished, and alienation from the legal system, particularly for persons of racial minorities.

necessary to fully protect their wages when that protection is available.<sup>106</sup>

In formulating the wage garnishment proposal ultimately submitted to the legislature, the California Law Revision Commission, again in reasonable anticipation of creditor opposition, rejected a suggestion advanced by some members of a state bar committee that judgment creditors afford a pre-levy notice of garnishment to judgment debtors.<sup>107</sup> Had pre-levy notice been required, debtors would have learned of impending wage garnishment *prior to* service of the earnings withholding order and would thus have been able to assert a claim of exemption prior to rather than after the beginning of withholding. Pre-levy notice seems particularly appropriate because the claim of exemption relates to wages allegedly necessary for the immediate support of the debtor or the debtor's family; if the claim of exemption is not granted until after some wages have been withheld, the debtor may experience significant hardship.

Pre-levy notice for wage garnishment appears even more appropriate than the pre-levy notice mandated where a judgment creditor seeks to execute against a residence of a judgment debtor which is potentially subject to the claimed residential exemption.<sup>108</sup> Even following execution sale of a residence, a debtor may not be dispossessed for a year;<sup>109</sup> yet, during the effective period of an earnings withholding order, prior to the granting of a claim of exemption and the return to the debtor of the garnished funds, the debtor is without the funds needed to buy food, pay rent, or pay for other necessary living expenses. The hardship can be particularly severe because a debtor may be deprived of the needed wages for as much as two months.<sup>110</sup> Yet it is certain that any proposal for pre-levy notice

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106. This assumption of literacy, or more precisely, functional competency, is probably unjustified. A significant percentage of the adult population of the United States is either incapable or only barely capable of understanding or acting upon simple instructions concerning basic living activities (e.g. following food recipes). See Div. of Extension, U. of Tex. at Austin, *Adult Functional Competency: A Summary* (Mar. 1975)(unpublished). There is a point, of course, at which debtor protection laws cannot, or cannot be expected to, compensate for educational deficiencies which may be attributable to a wide variety of social and economic problems. Deciding upon the extent to which debtor protection laws should accommodate the functionally incompetent is an enormously difficult question.

107. BAR COMM. REPORT, *supra* note 89, at 103 app. B-1.

108. CAL. CIV. PROC. CODE. § 690.31(d) (West Supp. 1979).

109. *Id.* § 702 (West Supp. 1979).

110. The two month period from the time wages are first withheld until they are returned to the debtor is an approximation calculated by totaling the maximum num-



would have been adamantly opposed by creditors.

The procedure for claiming a hardship exemption enacted by the Employees' Earnings Protection Law is similar to the procedure under the former law.<sup>111</sup> The debtor files a claim of exemption, accompanied by a financial statement, with the levying officer who forwards those forms, together with a notice of claim of exemption, to the judgment creditor. In absence of creditor opposition, the levying officer must serve the employer with an order terminating the earnings withholding order, and any funds withheld or transferred to the levying officer or creditor must be returned to the debtor. The judgment creditor may, of course, challenge the claim of exemption by serving the levying officer with a notice of opposition and by timely scheduling and notifying the levying officer and debtor of a hearing on the claim of exemption. If the claim of exemption is granted, funds withheld or transferred to the levying officer or creditor must be returned to the debtor.<sup>112</sup>

Where the debtor cannot prevail on a claim of exemption or doesn't wish to put up that fight, other measures for insolvency relief may be considered and recommended. Among those alternatives is a petition for liquidation and discharge under federal bankruptcy law.

#### LIQUIDATION AND DISCHARGE UNDER THE BANKRUPTCY REFORM ACT OF 1978

Debtors facing the prospect of liquidation and discharge (frequently referred to as "straight bankruptcy") usually wish to know the answers to three questions: "How much and what kind of property will I be able to keep?"; "What debts will I be able to eliminate?"; "What will be the effect of a bankruptcy upon my credit rating and my future ability to obtain credit?"<sup>113</sup> The Bankruptcy Reform Act of 1978,<sup>114</sup> most of

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ber of days for various acts of both creditor and debtor in a claim of exemption proceeding, including the time for mail delivery, *id.* § 723.105 (West Supp. 1979), and by adding thereto the two to four week period during which a debtor often must await the issuance of a check from the county treasury (to whose account the employer's payment by check to the levying officer may have already been credited).

111. Claims of exemption from wage garnishment were formerly governed by CAL. CIV. PROC. CODE § 690.50 (West Supp. 1979).

112. *Id.* § 723.105.

113. It is somewhat difficult to answer the debtor's question concerning the impact of a bankruptcy proceeding upon credit rating and upon the ability to obtain credit in the future. There are several possible responses to the question. One might

suggest that the client avoid incurring debt on all but major items (e.g. home or automobile) for some time if overuse of credit precipitated the current financial crisis. One might advise the client that post-bankruptcy availability of credit depends entirely upon individual creditors. Some will refuse extension of credit to all bankrupts. Others may be willing to extend credit to some bankrupts because the prospective debtor would generally be free from other debt and because discharge of newly created debt is barred in any subsequent bankruptcy commenced within six years of the filing of the petition in the first bankruptcy (see note 230 and accompanying text *infra*; but see text accompanying note 340 *infra*). Still others will base their decision upon the reason for the bankruptcy; a creditor might be more willing, for example, to extend credit to the person whose bankruptcy was precipitated by unexpected and uninsured medical expenses than to a person who filed bankruptcy to discharge debts incurred by the injudicious use of credit cards. Other creditors may be willing to extend credit if collateral will secure the loan (including purchase money loans for housing or automobiles).

Yet another response, cumulative to the others and of less immediate practical value, is to advise the client of his or her rights under fair credit reporting legislation. Under section 605 of the Fair Credit Reporting Act, as amended by section 312(b) of Title III of the Bankruptcy Reform Act of 1978, effective October 1, 1979, a credit reporting agency is prohibited from reporting a bankruptcy which, from the date of adjudication (an order for relief under the Bankruptcy Reform Act), antedates the report by more than ten years. Fair Credit Reporting Act, § 605, 15 U.S.C. § 1681c (1976), as amended by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 312(b), 92 Stat. 2676. This prohibition provides the consumer debtor with greater protection than does the analogous provision of California law, CAL. CIV. CODE § 1785.13(a)(1) (West Supp. 1979) which allows reporting of a bankruptcy for not to exceed fourteen years following the filing of a petition. Originally section 605 of the Fair Credit Reporting Act, Pub. L. No. 91-508, § 605, 84 Stat. 1129 (1970) (current version at 15 U.S.C. § 1681 (c)) allowed reporting for a period not exceeding fourteen years. Under the preemption provision of the Fair Credit Reporting Act, § 622, 15 U.S.C. § 1681t (1976), the now greater protection afforded by the federal law governs. If, however, applicable state law prohibited the reporting of a bankruptcy the petition for which antedated the credit report by a period of time less than ten years, that greater state law protection would govern.

Under California law, a very stale bankruptcy (e.g., antedating the report by twenty years) may nevertheless be reported if the report is being sought in connection with a credit transaction involving a principal amount of greater than \$50,000, or in connection with the underwriting of life insurance involving an amount greater than \$100,000, or in connection with employment of an individual at an annual salary exceeding \$30,000. CAL. CIV. CODE § 1785.13(b) (West Supp. 1979). In the analogous provision of the Fair Credit Reporting Act, § 605(b), 15 U.S.C. § 1681c(b) (1976), reporting of stale bankruptcies is permitted where the report is sought in connection with a credit transaction involving more than \$50,000, a life insurance policy involving more than \$50,000, or prospective employment involving a potential annual salary of in excess of \$20,000. In other words, the federal statute allows the reporting of stale bankruptcies in more cases than does the law of California and, under the preemption provision of the federal law, the state law on this issue governs.

The reporting of wage earners' proceedings (except in the specified "large" transactions described above) is apparently prohibited under identical language in the Fair Credit Reporting Act and the California Consumer Credit Reporting Agencies Act both of which bar disclosure of "any other adverse information which antedates the report by more than seven years." CAL. CIV. CODE § 1785.13(a)(7) (West Supp. 1979); Fair Credit Reporting Act, § 605(a)(6), 15 U.S.C. § 1681c(a)(6) (1976).

This information about credit reporting is sufficiently complicated and sufficiently peripheral to the concerns of most consumer debtors that the attorney will

which became effective October 1, 1979,<sup>115</sup> provides some important new answers to the first of these questions. With some exceptions to be discussed, the answers to the second and third questions remain the same as under the Bankruptcy Act of 1898.<sup>116</sup> The Bankruptcy Reform Act also includes some significant changes in wage earner proceedings, now termed Adjustment of Debts of An Individual With Regular Income, discussed in the succeeding section of this article.<sup>117</sup>

The Bankruptcy Reform Act effectuates a number of other far reaching and significant changes in bankruptcy law. There are changes relating to the jurisdiction of the bankruptcy court, the appointment and terms of the bankruptcy judges, the remuneration of trustees, the avoiding powers of the trustee, and business arrangements and reorganizations. For selected judi-

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rarily need to inform the client in any more than general terms of the client's rights under fair credit reporting legislation.

114. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549. The Bankruptcy Reform Act of 1978 contains four titles. Title I codifies and enacts the substantive law of bankruptcy as title 11 of the United States Code, effective October 1, 1979. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 402, 92 Stat. 2682 (effective date of Title I). References to sections of title 11 of the United States Code will hereinafter be cited to 11 U.S.C.A. (West Spec. Pamp. 1979). Title II amends title 28 of the United States Code and the Federal Rules of Evidence on matters relating to the organization, duties, powers and procedures in the bankruptcy courts. Title III contains amendments to and repeals miscellaneous provisions of the United States Code relating to bankruptcy. Title IV repeals the Bankruptcy Act of 1898, states effective dates of the provisions of the Bankruptcy Reform Act, and governs transition from the old to new law.

Legislative history of the Bankruptcy Reform Act includes H.R. REP. No. 595, 95th Cong., 2d Sess. 1, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963 [hereinafter cited as HOUSE REPORT] and S. REP. No. 989, 95th Cong., 2d Sess. 1, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787 [hereinafter cited as SENATE REPORT]. The final version of the Act is an amended version of H.R. 8200, 95th Cong., 1st Sess. 1 (1977), incorporating portions of the similar Senate bill, S. 2266, 95th Cong., 1st Sess. 1 (1977). See statement by Hon. Don Edwards (D. Ca.) upon introducing the House amendment to the Senate amendment in the nature of a substitute to H.R. 8200, 124 CONG. REC. H11,089 (daily ed. Sept. 28, 1978); statement by Hon. Dennis De Concini (D. Ariz.) explaining the House amendment to the Senate amendment in the nature of a substitute to H.R. 8200, 124 CONG. REC. S17,406 (daily ed. Oct. 6, 1978). The history of seven years of work preceding H.R. 8200 is summarized in HOUSE REPORT at 2-3 *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963-65.

115. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 402(a), 92 Stat. 2682. Cases pending on October 1, 1979 shall generally continue to be treated as if the Bankruptcy Reform Act had not been enacted. *Id.* § 403, 92 Stat. 2683.

116. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (formerly 11 U.S.C. §§ 1-1103 (1976)). The Bankruptcy Act of 1898 has been frequently amended since its enactment. Substantial revision was accomplished by the Chandler Act amendments of 1938. Act of June 22, 1938, ch. 575, 52 Stat. 883.

117. See text accompanying notes 304-359 *infra*.

cial districts, during a five year experimental period, a United States Trustee is created to perform functions heretofore performed by the bankruptcy judge. Explanation and evaluation of these and other changes are left to other forums because their impact on consumer insolvency counseling is peripheral. The focus here will be upon exemptions, discharge and dischargeability, and reaffirmations and redemptions. Because Title I of the Bankruptcy Reform Act of 1978 codifies the substantive law of bankruptcy as title 11 of the United States Code, section references in the text and in the notes will be made to title 11.

### *The "Federal Floor/State Ceiling" Exemption Scheme*

#### *An introduction*

Since its enactment in 1898, the Bankruptcy Act has provided that certain property deemed essential to the debtor's post-petition fresh start be preserved inviolate against the claims of creditors. Section 6 of the Bankruptcy Act of 1898 accomplished this purpose by establishing as exempt that property which would be exempt from execution under the non-bankruptcy laws of the United States and under the laws of the state in which the debtor was domiciled for a prescribed period of time preceding the filing of the bankruptcy petition.<sup>118</sup> Debate has long raged on the merits of this deference to state law.<sup>119</sup> Because the exemption statutes of each of the fifty states

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118. Bankruptcy Act of 1898, ch. 541, § 6, 30 Stat. 548, as amended by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 847 (formerly 11 U.S.C. § 24 (1976)) reads in part:

This Act shall not affect the allowance to bankrupts of the exemptions which are prescribed by the laws of the United States or by the State laws in force at the time of the filing of the petition in the State wherein they have had their domicile for the six months immediately preceding the filing of the petition, or for a longer portion of such six months than in any other State. . . .

119. For discussion concerning the exemption scheme of the Bankruptcy Act of 1898, see Countryman, *For A New Exemption Policy in Bankruptcy*, 14 RUTGERS L. REV. 678 (1960); Kennedy, *Limitation of Exemptions In Bankruptcy*, 45 IOWA L. REV. 445 (1960); Comment, *Bankruptcy Exemptions: A Full Circle Back To The Act of 1800?*, 53 CORNELL L. REV. 663 (1968); Comment, *Bankruptcy Exemptions: Critique and Suggestions*, 68 YALE L.J. 1459 (1959).

Section 6's "patchwork" exemption policy was criticized not only because of the lack of uniformity resulting from its incorporation of disparate state exemptions, but also because it seemed to conflict with the underlying rehabilitative purpose of the Bankruptcy Act to give the bankrupt debtor a "fresh start". Countryman, *supra*, at 680-84. "This rehabilitative purpose is served not only by the discharge provisions of the Act, but also by the exemption provisions. But it is not well served by committing the bankruptcy exemption policy to the parsimony and neglect of the state legislature." *Id.* at 684.

differ, often substantially,<sup>120</sup> section 6 has been criticized as inequitable. At the same time, a uniform national exemption scheme might also be unfair because of its failure to accommodate the varying standards of living in the fifty states.

A variety of suggestions has been advanced in response to the perceived inequities of section 6. The Commission on the Bankruptcy Laws of the United States proposed a somewhat flexible uniform set of exemptions in bankruptcy.<sup>121</sup> Near the end of the long journey of proposed bankruptcy reform, the Senate proposed that the Bankruptcy Reform Act retain the section 6 approach deferring to non-bankruptcy exemption

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Though section 6's exemption scheme was condemned by many, it had its defenders. Professor Kennedy, while noting that section 6 resulted in harsher treatment of bankrupt debtors in states with limited exemptions (particularly in the Northeast), maintained that this could be attributed to a difference in the appraisal of the relevant interests by the legislatures of the states where they live. Kennedy, *supra*, at 449. "[N]either creditor nor debtor interests are so disproportionately represented in state legislatures as to require federal intervention to protect their interests for the sake of a sound national economy." *Id.* at 453.

120. This disparity may be exemplified by a comparison of the homestead exemptions of New York, Texas and California. New York law provides that specified types of residential property, a lot of land with a dwelling, shares of stock in a cooperative apartment, or units of a condominium apartment, are exempt from execution to the extent of \$10,000 in value above liens and encumbrances. N.Y. CIV. PRAC. LAW § 5206(a) (McKinney 1978). Such property is exempt only if used as the principal residence of the homestead claimant, and the exemption automatically "ceases" when the property is no longer occupied by the claimant. *Id.* § 5206(c).

In contrast to the New York scheme, the Texas homestead provisions exempt real property in any amount if the property is rural. TEX. CONST. ANN. art. 16, §§ 50-51 (Vernon Supp. 1979). If the property is urban, "in a city, town, or village," the exemption for a homestead is limited to \$10,000. The Texas exemption applies to property used either as a residence or "as a place to exercise the calling or business" to provide for a family or a single adult person. *Id.* § 51. The homestead is not abandoned even though the claimant resides elsewhere or temporarily rents the homestead property, so long as no other homestead is acquired, unless the claimant abandons the property without intent to return. *Id.*; *West v. Austin Nat'l Bank*, 427 S.W.2d 906 (Tex. Civ. App. 1968).

The California provisions exempt real property consisting of the dwelling house in which the claimant resides (and the land and outbuildings); a head of a family may claim \$40,000 exempt over and above the value of all liens and encumbrances. CAL. CIV. CODE § 1237 (West 1954 & Supp. 1979) (property constituting homestead); *id.* § 1260 (West Supp. 1979) (amount); CAL. CIV. PROC. CODE § 690.31 (West Supp. 1979) (claimed residential exemption).

For a brief summary of the various types of state exemption schemes, see Karlen, *Exemptions From Execution*, 22 BUS. LAW. 1167 (1967). See also Kennedy, *supra* note 119, at 447 n.10 (types of exemption laws) (citing Joslin, *Debtors' Exemption Laws: Time for Modernization*, 34 INP. L.J. 355 (1959)).

121. COMM'N ON THE BANKRUPTCY LAWS OF THE U.S., REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137, 93rd Cong., 1st Sess. 1, pt. II (1973).

law.<sup>122</sup> The scheme finally adopted, however, is a modification of the "federal floor/state ceiling" concept proposed by the House.<sup>123</sup> This new exemption scheme offers fascinating new opportunities for protecting property of debtors who file a petition for liquidation and discharge.<sup>124</sup>

Under the exemption scheme of the Bankruptcy Reform Act, set forth in section 522 of title 11,<sup>125</sup> the debtor is offered a choice between the exemptions available under non-bankruptcy exemption law (as under section 6 of the Bankruptcy Act)<sup>126</sup> and the alternative exemptions provided in section 522(d) of title 11, "unless the State law that is applicable to the debtor . . . specifically does not so authorize . . ."<sup>127</sup> This quoted language was intended to compromise the House exemption scheme (offering the debtor the choice between non-bankruptcy exemptions and section 522(d) exemptions) with the Senate exemption scheme (deferring exclusively to non-

122. S. 2266, 95th Cong., 1st Sess., Title I, § 522(b)(1977).

123. H.R. 8200, 95th Cong., 1st Sess., Title I, § 522(b)(1977).

124. In the Bankruptcy Reform Act the term "bankrupt" is replaced by the term "debtor". 11 U.S.C.A. § 101(12) (West Spec. Pamp. 1979).

125. The full text of section 522 is long enough that full reproduction here seems inappropriate. Selected subsections discussed in the text will be reproduced in footnotes accompanying that text. Section 522(b) reads in part:

Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate either — (1) property that is specified under subsection (d) of this section, unless the State law that is applicable to the debtor under paragraph (2)(A) of this subsection specifically does not so authorize; or, in the alternative, (2)(A) any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor's domicile has been located for the 180 days immediately preceding the date of the filing of the petition, or for a longer portion of such 180-day period than in another place; . . .

11 U.S.C.A. § 522(b) (West Spec. Pamp. 1979). Section 541 of title 11 provides that commencement of a case under title 11 (including a liquidation under chapter 7 and an adjustment of debts under chapter 13) creates an estate; section 541 describes the property of the estate. *Id.* § 541. The Technical Amendments Act, S. 658, 96th Cong., 1st Sess. 1 (1979) reprinted in 125 CONG. REC. S2736 (daily ed. Mar. 14, 1979), proposes to replace the words "does not so authorize" with the words "prohibits application of such subsection (d)". The substitute language would eliminate ambiguity.

126. The phrase "non-bankruptcy exemption law" will be used in the text in lieu of the more cumbersome language of section 6 quoted in note 118 *supra*. Non-bankruptcy exemption law consists of exemptions under state law (*e.g.*, CAL. CIV. PROC. CODE §§ 690.1-.52 (West Supp. 1979)) and under non-bankruptcy laws of the United States (*e.g.*, Veterans' Administration Benefits, 38 U.S.C.A. § 3101(a) (West Supp. 1979)).

127. The context of the quoted language and proposed clarifying language appears in note 125 *supra*.

bankruptcy exemptions).<sup>128</sup> The compromise allows the debtor a choice unless a state legislature, seeing the section 522(d) exemptions as too generous, specifically prohibits the debtor from choosing the section 522(d) exemptions.

By offering the debtor a choice, in the absence of state veto, the Bankruptcy Reform Act assures to each debtor a federally defined minimum amount of property for a fresh start (the federal floor). At the same time, the Bankruptcy Reform Act accommodates the potentially greater needs of debtors in individual states by allowing the debtor to choose state exemptions if they offer greater protection (the state ceiling). It would appear that the debtor must choose one or the other *set* of exemptions in its entirety and cannot select some non-bankruptcy exemptions and some exemptions from section 522(d).<sup>129</sup> The statute does not identify the time at which the choice must be made, nor does it specifically countenance or prohibit a change of mind in the event of an improvident initial choice.<sup>130</sup> Presumably the new Bankruptcy Rules<sup>131</sup> will speak

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128. See notes 122-23 and accompanying text *supra*.

129. This would appear clear from, among other things, the grammar of section 522(b)(1) in which a semi-colon follows the word "authorize" and precedes the word "or". Section 522(b)(1) is quoted in full at note 125 *supra*. The same would be true after the amendment to this language proposed by the Technical Amendments Act. See note 125 *supra*.

130. Section 522(l) provides, simply:

The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section. If the debtor does not file such a list, a dependent of the debtor may file such a list, or may claim property as exempt from property of the estate on behalf of the debtor. Unless a party in interest objects, the property claimed as exempt on such list is exempt.

11 U.S.C.A. § 522(l) (West Spec. Pamp. 1979).

131. New Rules of Bankruptcy, including new official forms, are anticipated. HOUSE REPORT, *supra* note 114, at 292-93, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6249-50. Matters which will be dealt with by the Rules or by local rules are listed *id.* at 293-308. Concerning exemptions, see *id.* at 296. Unlike Rules implementing the Bankruptcy Act of 1898, the Rules implementing the Bankruptcy Reform Act may not conflict with provisions of the Bankruptcy Reform Act, because the Bankruptcy Reform Act struck from 28 U.S.C. § 2075 the following sentence: "All laws in conflict with such rules shall be of no further force or effect after such rules have taken effect." Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 247, 92 Stat. 2672. The possibility of any conflict is minimized because the Bankruptcy Reform Act, unlike the Bankruptcy Act, contains little of a procedural nature, leaving most such matters to the Rules. HOUSE REPORT, *supra* note 114, at 292-93, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6249-50. Until the new Rules are effective, present Rules will continue in effect to the extent not inconsistent with the Bankruptcy Reform Act or amendments made thereby. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 405(d), 92 Stat. 2685. It is clear that new Rules will not be finally approved until well past the effective date of the Bankruptcy Reform Act. It is likely that most districts will be operating

to these issues. On the basis of legislative history, it seems realistic to expect that the rules will require the choice to be made at the time the petition is filed, or shortly thereafter, but also allow for a court to entertain a motion to amend the debtor's claims of exemption in appropriate circumstances.<sup>132</sup>

The legislative history of the Bankruptcy Reform Act suggests that pre-petition conversions of non-exempt to exempt property remain permissible in the absence of a showing of actual intent to defraud creditors.<sup>133</sup> Many cases decided under the Bankruptcy Act of 1898, notably *In Re Dudley*,<sup>134</sup> sanction this important aspect of pre-petition planning even though such conversions of non-exempt property reduce (often to zero) the amount of assets which would otherwise be available to creditors in bankruptcy.<sup>135</sup> In fact, insolvency counseling would be inadequate, perhaps malpractice, were the attorney to fail to suggest possible conversions (consistent with the holdings of cases such as *In Re Dudley*) prior to the filing of a petition. If full conversion cannot be accomplished, the client should certainly be advised that non-exempt property will be lost to (or will have to be purchased by the debtor from) the trustee, unless abandoned,<sup>136</sup> and that other alternatives, such as an

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from suggested interim local rules which the Rules Committee intends to propose pending action on final Rules and that existing forms shall be appropriately adapted to use under the Bankruptcy Reform Act.

132. The House report states:

The Rules will provide for the situation where the debtor's choice of exemption, Federal or State, was improvident and should be changed, for example, where the court has ruled against the debtor with respect to a major exemption.

HOUSE REPORT, *supra* note 114, at 360, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6316.

133. As under current law, the debtor will be permitted to convert non-exempt property into exempt property before filing a bankruptcy petition . . . . The practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemptions to which he is entitled under the law.

*Id.* at 361, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6317.

134. *In re Dudley*, 72 F. Supp. 943 (S.D. Cal. 1947), *aff'd*, 166 F.2d 1023 (9th Cir. 1948); *accord*, *Rutledge v. Johansen*, 270 F.2d 881 (10th Cir. 1959); *In re Hygrade Envelope Corp.*, 393 F.2d 60 (2d Cir.), *cert. denied*, 393 U.S. 837 (1968); *In re Smith*, 366 F. Supp. 1213 (D. Idaho 1973).

135. Approximately ninety percent of all bankruptcies are individual consumer bankruptcies and of these approximately eighty percent are no asset or nominal asset bankruptcies. *See, e.g., House Hearings, supra* note 8, at 767.

136. Assets of the estate which are only partially exempt, especially automobiles, are almost invariably purchased by the debtor from the trustee. *See, e.g., id.* at 771, 781. Under section 554 of title 11, the trustee may abandon any property of the estate



adjustment of debts, might avoid those consequences.<sup>137</sup> Given the importance of pre-petition planning to effective and competent insolvency counseling, it is somewhat surprising to see this practice addressed only in the legislative history and not in the explicit language of the statute. It may be, however, that the drafters did not wish to tamper with the developed case law on the subject for fear of inviting litigation with any statutory language which they might have chosen.

Many of the exemptions specified in section 522(d) refer to specific dollar amounts of property.<sup>138</sup> It is important to remember that under section 104 of title 11 those dollar amounts are subject to adjustment for inflation upon action by the Congress and the President following recommendation by the Judicial Conference of the United States prior to May 1, 1985, and prior to May 1 of every sixth year after May 1, 1985.<sup>139</sup> Moreover, any exemptions available under non-bankruptcy law are also subject to periodic adjustment for inflation; under the laws of some states, adjustment may be automatic.<sup>140</sup>

### *Making the choice*

It seems useful to illustrate the types of decisions that this new exemption scheme will necessitate in the counseling of California debtors planning to file petitions for liquidation and discharge. The chart reproduced at page 858 may assist the

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which is burdensome to the estate or that is of inconsequential value to the estate. 15 U.S.C.A. § 554(a) (West Spec. Pamp. 1979).

137. In a proceeding to adjust debts of an individual with regular income, discussed in the succeeding section of this article, an estate is created, *see* note 125 *supra*, but confirmation of a plan vests all of the property of the estate in the debtor. 11 U.S.C.A. § 1327(b) (West Spec. Pamp. 1979).

138. For example, section 522(d)(2) refers to the debtor's interest, not to exceed \$1200 in value, in one motor vehicle. *Id.* § 522(d)(2).

139. *Id.* § 104. Section 104 applies to all dollar amounts in title 11 and to section 1930 of title 29 (filing fees). *Id.* Section 104 accomplishes little more than what Congress and the President can always do anyway: enact legislation increasing the amount of exemptions available in bankruptcy. The section does, however, require recommendations every six years from the Judicial Conference of the United States to Congress and the President and those recommendations are likely to induce legislation to increase dollar amounts in the exemption provisions. An increase in cost of living does not necessarily mandate an adjustment of dollar amounts for exemptions or for other provisions of title 11 or for section 1930 of title 28. SENATE REPORT, *supra* note 114, at 28-29, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5814-15.

140. The California Law Revision Commission, which is drafting a comprehensive reform of the state's enforcement of judgment provisions, including its exemption provisions, proposes a clause for an automatic cost of living escalator. *See* COMM'N TENTATIVE RECOMMENDATION, *supra* note 22, at 98-100.

illustration. The chart compares the most commonly significant exemptions available under California law with the roughly corresponding alternative exemptions afforded by section 522(d) of title 11.<sup>141</sup> The chart is only partial; it does not list every exemption afforded by California law or by section 522(d) of title 11. The chart is also over-simplified and hence is in some respects inaccurate. For example, the California residential exemption is listed as \$25,000. That amount is the exemption available to a single person under the age of sixty-five, effective January 1, 1979,<sup>142</sup> ignoring potential problems of retroactivity<sup>143</sup> and other complexities associated with the protection of residences in California.<sup>144</sup> The purpose of the over-simplification is to make the chart manageable and useful.

Disregarding, for the moment, other exemptions that are available under California law or under section 522(d), the comparisons offered in the chart suggest several important rules of thumb.

(1) All other things being equal, if the debtor's equity in a residence is substantial, the California exemptions will probably be the most provident choice. For example, for the single debtor who owns a home with an equity of \$15,000, the California declared homestead or claimed residential exemption will protect the total amount of that equity,<sup>145</sup> whereas section 522(d) will protect only one-half of that amount.<sup>146</sup> It will be a rare case where the loss of \$7,500 exempt residential equity through choice of section 522(d) exemptions would be offset by

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141. Although the exemption scheme of the Bankruptcy Reform Act allows a choice between section 522(d) exemptions and exemptions available under *non-bankruptcy law*, including non-bankruptcy laws of the United States, the chart and the discussion in the text simplifies the issue of choice somewhat by treating non-bankruptcy exemption law as if it consisted exclusively of California exemption law. This is for purposes of illustration only.

142. CAL. CIV. CODE § 1260 (West 1954 & Supp. 1979); CAL. CIV. PROC. CODE § 690.31(a) (West Supp. 1979).

143. For discussion of problems of retroactive application of increases in amounts of exemptions to creditors whose claims arose prior to the increase, see text accompanying notes 203-21 *infra*.

144. The relationship between the California declared homestead law, CAL. CIV. CODE §§ 1237-1304 (West 1954 & Supp 1979) and the California claimed residential exemption, CAL. CIV. PROC. CODE § 690.31 (West Supp. 1979), is explored in Adams, *supra* note 24, at 737-53 (1978); *Review of Selected 1977 California Legislation*, 9 PAC. L.J. 375, 375-77 (1978); *Review of Selected 1976 California Legislation*, 8 PAC. L.J. 226, 226-28 (1977).

145. CAL. CIV. CODE § 1260 (West 1954 & Supp. 1979); CAL. CIV. PROC. CODE § 690.31(a) (West Supp. 1979).

146. 11 U.S.C.A. § 522(d)(1) (West Spec. Pamp. 1979).

Type of Property	Maximum Exempt Amount of Individual Debtor's Equity†	
	Section 522(d)	California
Residence††	\$7,500.	\$25,000.
Motor Vehicle	\$1,200.	\$500.
Household furnishings, wearing apparel, books, animals, crops, musical instruments	\$200. for any single item, with no limit on the aggregate	No dollar limit; must be reasonably necessary to and personally used by debtor
Jewelry	\$500.	No comparable exemption†††
Tools of trade*	\$750.	\$2,500.
Funds in savings & loan	No provision	\$1,000.
Funds in credit union	No provision	\$1,500.
Residual amount of any property	\$400. plus any unused portion of residential exemption**	No comparable exemption
Health aids	No limit	No limit

*Notes to Chart:*

† See text accompanying notes 155-68 *infra*, for discussion of exemptions in the case of husband and wife filing a petition in a *joint* case. The amounts listed here are drawn from sections 522(d)(1), 522(d)(2), 522(d)(3), 522(d)(4), 522(d)(5), 522(d)(6), and 522(d)(9) of title 11 and sections 690.1, 690.2, 690.4, 690.5, 690.7, and 690.31 of the California Code of Civil Procedure, section 1260 of the California Civil Code, and section 15406 of the California Financial Code.

†† Under section 522(d)(1) of title 11, the \$7,500 exemption for a residence includes the debtor's interest in real or personal property that the debtor or dependent of the debtor uses as a residence and in a cooperative that owns property used by the debtor or dependent of the debtor for a residence, and also includes the debtor's interest in a burial plot. Since the residence may be either real or personal property, mobile homes or vessels used as a residence are presumably included. California exempts mobile homes or houseboats as well as real property residences, CAL. CIV. PROC. CODE § 690.3 (West Supp. 1979), but separately exempts burial plots in an unlimited amount, *id.* § 690.24. Thus, under California exemptions, unlike the section 522(d) exemptions, the debtor would not be put to the choice between a residence and a burial plot.

††† Some jewelry, such as a wedding band, is arguably exempted under section 690.1 of the California Code of Civil Procedure which exempts wearing apparel ordinarily and reasonably necessary to and personally used by the debtor. See *Estate of Millinstein*, 63 Cal. App. 498, 218 P. 1022 (1923).

\* In California, tools of the trade are specifically defined to include one commercial motor vehicle reasonably necessary to and actually used in a commercial activity, CAL. CIV. PROC. CODE § 690.4 (West Supp. 1979). Thus, equity in a motor vehicle not protected under California Code of Civil Procedure section 690.2 might nevertheless be protected if used in a commercial activity.

\*\* Thus, for example, a debtor who rents an apartment for a residence is entitled to claim exempt \$7,900 in value of any property.

a comparable gain in exemptions of other property through choice of the section 522(d) exemptions rather than California exemptions.

(2) All other things being equal, if the debtor rents living accommodations and therefore could not claim any residential exemption, section 522(d) exemptions will be the most provident choice because the debtor is thereby afforded an exemption of \$7,900 in *any* property *in addition to* the other exemptions listed in section 522(d). Nothing in the California exemptions approaches the generosity of this "grubstake" exemption.

(3) All other things being equal, if the fair market value of individual items of household furniture, appliances, musical instruments and such is high, choice of the California exemptions will be more beneficial because, unlike section 522(d) exemptions, California law does not establish a dollar limit on the value of individual household items which may be exempted. Rather, household furnishings are exempt as long as they are ordinarily and reasonably necessary to and personally used by the debtor and his or her resident family.<sup>147</sup>

(4) All other things being equal, if the debtor owns an automobile with substantial equity, he or she would profit by choosing the section 522(d) exemptions which would protect \$1,200 of that equity; the California motor vehicle exemption would protect only \$500 equity.<sup>148</sup>

(5) All other things being equal, if the debtor owned a substantial amount of tools used in his or her trade or profession, he or she would be advantaged by choice of the California exemptions rather than the section 522(d) exemptions because of the significantly higher amount of protection offered by the California tools of the trade exemption.<sup>149</sup>

Of course, the difficulty in making the decision between the California exemptions and the section 522(d) exemptions is that all other things are not usually equal. Thus, a debtor to whose advantage it would be to claim the California exemptions because of substantial equity in a home would be disadvantaged by such a choice if he or she owned a motor vehicle

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147. CAL. CIV. PROC. CODE § 690.1 (West Supp. 1979). Case law in California makes clear that the determination of what constitutes reasonable and necessary household furnishings is to be made in the context of the debtor's station in life. *Newport Nat'l Bank v. Adair*, 2 Cal. App. 3d 1043, 83 Cal. Rptr. 1 (1969); *Independence Bank v. Heller*, 275 Cal. App. 2d 84, 79 Cal. Rptr. 868 (1969).

148. CAL. CIV. PROC. CODE § 690.2 (West Supp. 1979).

149. *Id.* § 690.4.

with an equity exceeding \$500 (the maximum exempt amount under California law) because of the \$1,200 exemption allowed under section 522(d), or if he or she were the beneficiary of an award under a crime victim's reparation law, also exempt under section 522(d)<sup>150</sup> but not under California law. The ultimate choice, then, must be made by evaluating the net gain to be obtained by choosing one or the other set of exemptions after allowing for all feasible pre-petition conversions of non-exempt property. Two hypothetical cases are offered to illustrate the process of choice.

Client A is an unmarried male who wants to file bankruptcy to discharge a large personal injury judgment in excess of insurance coverage (and thus reinstate a suspended driver's license). Assuming that the judgment were dischargeable under section 523,<sup>151</sup> and that the bankruptcy were otherwise advisable, the counselor and client would need to decide which exemptions to choose and what pre-petition conversions, if any, should be undertaken to maximize the amount of property which the debtor could retain for his fresh start. The choice might initially appear difficult if the client's assets consisted of the following (values stated are amounts above any liens and encumbrances):

Real property residence	\$12,000.
Automobile	\$ 1,250.
Shares of common stock	\$ 500.
Tools of trade	\$ 250.
Household goods/furnishings	\$ 5,000. including several expensive antiques and a grand piano
Award for wrongful death of wife in auto accident (unrelated to personal injury judgment against client)	\$ 7,500.

Absent any pre-petition conversions, choice of section 522(d) exemptions would protect all save \$50 of the automobile, the tools of the trade, all items of furniture individually valued at less than \$200, and probably most if not all of the award for wrongful death,<sup>152</sup> but that choice would sacrifice

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150. 11 U.S.C.A. § 522(d)(11)(A) (West Spec. Pamp. 1979).

151. Dischargeability of debts is discussed in the text accompanying notes 245-85 *infra*.

152. Payment on account of wrongful death of an individual of whom the debtor was a dependent is exempt to the extent reasonably necessary for the support of the

\$4,100 of equity in the home (applying the section 522(d)(5) "grubstake" allowance to the home), the common stock, and all items of furniture valued at more than \$200. Conversely, choice of the California exemptions (again, absent any pre-petition conversions) would protect the entire equity in the home, the tools of the trade, and probably all of the furniture, but sacrifice \$750 of equity in the automobile, the stock, and all of the wrongful death award. Absent pre-petition conversions, then, choice of section 522(d) exemptions would protect a total of \$16,850 in value of property plus all of the furniture valued at less than \$200 per item, and the choice of California exemptions would protect a total of \$12,750 in value of property plus, perhaps, all \$5,000 worth of furniture. Without an appraisal of the furniture and without being able to predict what amount of the wrongful death award the bankruptcy court might rule to be exempt, the choice would be troublesome.

Pre-petition conversions might simplify or mandate the choice by protecting greater amounts of property. Fifteen hundred dollars of the wrongful death award could be deposited in a credit union and \$1,000 could be deposited in a savings and loan account (some of which could then be used to purchase the trustee's \$750 interest in the automobile); the remaining funds (\$5,000 from the wrongful death award and \$500 from liquidation of the stock) could be used to purchase up to \$2,250 worth of tools of the trade and additional furniture and household goods. Alternatively, some or all of the cash could be used to reduce the debt to debtor's real property secured creditor, although this might require payment of a prepayment penalty. Although the trustee might seek to claim some of the household goods and furnishings as not reasonably necessary to the debtor, the debtor will nevertheless have protected a greater amount of property by choosing the California exemptions after these conversions than by choosing either the California or section 522(d) alternative without such conversions.

Clients Mr. and Mrs. B are a married couple who want to file bankruptcy to discharge their liability for uninsured medical expenses of \$30,000 incurred in the treatment of their son for a severe spinal injury suffered while playing football. Their assets consist of the following community property (values listed are amounts beyond liens and encumbrances):

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debtor and any dependent of the debtor. 11 U.S.C.A. § 522(d)(11)(B) (West Spec. Pamp. 1979).

Real property residence	\$13,500.
Household goods/furnishings	\$ 5,000. (none exceeding \$200 in value)
Automobiles	
1976 Buick	\$ 2,500.
1972 Pinto	\$ 350.
Husband's tools of trade	\$ 2,000.
Grand piano	\$ 7,500.
Award under crime victim's reparation law	\$ 7,000.

Absent pre-petition conversions, the choice of section 522(d) exemptions would protect all of the equity in the home, all of the household goods and furnishings but not the grand piano, all the husband's tools (using sections 522(d)(6) and 522(d)(5)), \$2,400 in value in the automobiles,<sup>153</sup> and all of the award under the crime victim's reparation law. Choice of the California exemptions without pre-petition conversions would also protect the entire equity in the home, all of the household furnishings including, probably, the grand piano, all of the husband's tools of the trade, only \$500 in value of the automobiles, and none of the award under the crime victim's reparation law. In short, choice of section 522(d) exemptions would protect a total of \$29,900 in value of property and choice of the California exemptions would protect a total of \$28,500 worth of property. However, through pre-petition conversions the debtors could protect all their property under the California exemptions.

Any number of pre-petition conversions would make this possible. For example, the debtors could sell the 1972 Pinto, and mortgage the 1976 Buick as security for a \$2,000 loan from a relative, and use the \$350 proceeds from the sale of the Pinto to pay attorney's fees for the bankruptcy and deposit the \$2,000 loan proceeds in two separate savings and loan accounts (the money later to be used, if desired, for a down payment on another car). They could use the \$7,000 award under the crime victim's reparation law to reduce the mortgage on the house, although this might involve pre-payment penalty and would reduce income tax benefits.

These two examples have illustrated the ways in which the insolvency counselor and insolvent debtor can plan to preserve

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153. See text accompanying notes 156-66 *infra*.

the greatest amount of property for the debtor's post-petition fresh start. There is more to be considered, however, because there is much more to the section 522 exemption scheme.

*Some complications and variations*

Section 522(m) provides that section 522 applies to each debtor in a joint case (husband and wife) and raises a question about the relationship of some of the exemption scheme of section 522 to California community property law. Section 522(f) through 522(j) empower the debtor to exempt certain property that has been transferred prior to the filing of the petition but which may be recaptured for the estate. In addition, section 522 does not purport to resolve the continuing controversy concerning the retroactive application of increases in dollar amounts of exemptions to creditors whose claims antedate the increase. Each of these three important aspects of bankruptcy exemption law, exemptions in a joint case, avoidance of pre-petition transfers, and retroactive application of changes in exemptions, is the subject of ensuing discussion.

*Exemptions in joint cases.* Section 302 of title 11 permits a debtor and the debtor's spouse to commence a joint case by the filing of a single petition.<sup>154</sup> Section 522(m) of title 11 provides that section 522 "shall apply separately with respect to each debtor in a joint case."<sup>155</sup> Accordingly, each debtor in a joint case is entitled to make the choice of exemptions allowed by section 522(b). The allowance to each debtor in a joint case of the right to choose either non-bankruptcy exemptions or section 522(d) exemptions raises some interesting and important questions, two of which are addressed here.

Section 522(d)(2) protects "the debtor's interest, not to exceed \$1,200, in one motor vehicle."<sup>156</sup> It is not clear in all cases what that "interest" is under California community property law. Clearly, if each spouse were the owner of a separate property motor vehicle, each would be entitled to claim exempt \$1,200 in value in their respective motor vehicles if

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154. 11 U.S.C.A. § 302 (West Spec. Pamp. 1979) reads as follows:

A joint case under a chapter of this title is commenced by the filing with the bankruptcy court of a single petition under such chapter by an individual that may be a debtor under such chapter and such individual's spouse. The commencement of a joint case under a chapter of this title constitutes an order for relief under such chapter.

155. *Id.* § 522(m).

156. *Id.* § 522(d)(2).



both chose to utilize section 522(d) exemptions. It is problematic whether the same result (\$2,400 in value in motor vehicles exempt) would follow if the spouses owned one or more community property vehicles and if each of them had otherwise exhausted the "grubstake" exemption of section 522(d)(5).<sup>157</sup>

In the context of dissolution of marriage, or death of one spouse, California law provides for equal division of community property.<sup>158</sup> Accordingly, in dissolution, half of any item of community property or half of its value may be awarded to each person,<sup>159</sup> and, following death of one spouse, half of any item of community property or half of its value will devolve to the surviving spouse and half will be subject to testamentary disposition of the decedent.<sup>160</sup> If that characterization of a spouse's interest in community property were carried forward to the bankruptcy exemption context, one might argue that the debtor's interest in one community property motor vehicle would be one-half of its dollar value. If the spouses owned without encumbrance one community property motor vehicle with a value not exceeding \$2,400 each spouse could claim \$1,200 exempt and the entire vehicle could be protected. If, however, the spouses owned without encumbrance two community property vehicles, each with a value of \$1,200, their respective interests in each would be \$600 and they therefore could only protect one of the two motor vehicles because each could claim their interest in only *one* motor vehicle.<sup>161</sup>

There are good reasons for rejecting this analysis. First, husband and wife could easily protect both motor vehicles in the example just posed by agreeing orally, prior to the filing of the petition, to convert each vehicle from community property to the separate property of each one of the spouses.<sup>162</sup> Through

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157. Because any specific resolution of the issue discussed in the text is not clearly predictable, it may be advisable for the debtor to avoid the issue by insuring that he or she has available sufficient "grubstake" exemption to protect any motor vehicle sought to be preserved as exempt.

158. CAL. CIV. CODE § 4800 (West Supp. 1979); CAL. PROB. CODE § 201 (West 1956).

159. CAL. CIV. CODE § 4800 (West Supp. 1979). That section also empowers a court to "award any asset to one party on such conditions as it deems proper to effect a substantially equal division of the property." *Id.*

160. CAL. PROB. CODE § 201 (West 1956).

161. This issue will not arise in the context of other exemptions listed in section 522(d) because in none of those other exemptions is the debtor limited to a claim of exempt value in *one* item.

162. Estate of Neilson, 57 Cal. 2d 733, 371 P.2d 745, 22 Cal. Rptr. 1 (1962); Woods v. Security-First Nat'l Bank, 46 Cal. 2d 697, 299 P.2d 657 (1956); Mooney v.

that device, each spouse could claim the total value of one \$1,200 motor vehicle as exempt. This bit of pre-petition planning would be easy and it would also be a trap for the unwary. Certainly the bankruptcy court should not deny exemption for an equal total value of motor vehicles in a case where the spouses were unaware of their right to orally agree to convert community property to separate property.

Second, because any creditor executing a judgment can reach the entire non-exempt amount of any item of community property by virtue of the contract of only one spouse,<sup>163</sup> it would be consistent to argue that each spouse in a bankruptcy case should be entitled to claim the full amount of an exemption for any item of community property even if that amount exceeds one half of the total value of the property. Thus, if husband and wife owned two community property vehicles each worth \$1,200, one spouse should be entitled to claim the entire value of one motor vehicle exempt and the other spouse should be entitled to do the same for the other motor vehicle. This result would be consistent with, though not specifically supported by, the fact that the "respective interests of the husband and wife in community property during continuance of the marriage relation are present, existing and equal interests"<sup>164</sup> and that, with certain exceptions, "either spouse has the management and control of the community personal property."<sup>165</sup> The ultimate resolution of this issue should, of course, depend on whether Congress intended, through the operation of section 522(d)(2), section 522(m), and community property law, to protect one vehicle per family or rather intended to protect \$2,400 in value of motor vehicles per family, but there is nothing in the legislative history to indicate congressional intent.<sup>166</sup>

A second question posed by the operation of section 522(m) will arise in the case where one spouse chooses section 522(d) exemptions and the other debtor chooses non-bankruptcy exemptions. Was it truly the drafters' intent, for example, that a

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Mooney, 91 Cal. App. 2d 118, 204 P.2d 630 (1949).

163. CAL. CIV. CODE § 5116 (West Supp. 1979).

164. *Id.* § 5105.

165. *Id.* § 5125.

166. An analagous issue under California law involving exemption of funds deposited in a savings and loan association was resolved when the California legislature re-enacted former section 690.21 of the California Code of Civil Procedure as section 690.7 of that Code and stated that the exemption "shall be a maximum of one thousand dollars (\$1,000) per person, whether the character of the property be separate or community." CAL. CIV. PROC. CODE § 690.7 (West Supp. 1979).

husband in California who is the head of a household could claim \$40,000 in value of a residence exempt under the California declared homestead or claimed residential exemption<sup>167</sup> and that the wife would choose the section 522(d) exemptions to protect an additional \$7,500 in value of equity in that residence? This result flies clearly in the face of the intent of the California legislature to protect only \$40,000 in value of equity in a residence for a family, yet it appears to be the result compelled by the plain meaning of the statutory language. Of course, the congressional compromise on exemptions in bankruptcy reflected in section 522(b) permits a state to enact legislation which will prohibit any debtor from choosing section 522(d) exemptions. This authority will very likely be used in those states where exemptions are not nearly so generous as the section 522(d) exemptions and where the state does not wish to countenance the generosity of the section 522(d) exemptions. California would probably not enact such legislation because its exemptions, especially the declared homestead and claimed residential exemption, are more generous than those allowed under section 522(d). Yet in the example posed, split choices of exemptions in a joint case, there might be incentive for the California legislature to consider such legislation.

It is not clear whether the language of section 522(b), which allows a state to prohibit a debtor from choosing exemptions under section 522(d), would allow the California legislature to permit a debtor generally to choose section 522(d) exemptions but restrict that option in a joint case where the combined exemptions resulting from the choice by one spouse of non-bankruptcy exemptions and choice by the other spouse of section 522(d) exemptions would exceed the amount otherwise exempt to joint debtors if they both chose non-bankruptcy exemptions. It would be unfortunate if such a limited prohibition were not permissible under the language of section 522(b) because, at least in California, there would be good reason for the limited prohibition but no good reason for a broader prohibition entirely precluding the debtor's choice of section 522(d) exemptions.<sup>168</sup>

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167. CAL. CIV. CODE § 1260 (West 1954 & Supp. 1979); CAL. CIV. PROC. CODE § 690.31(a) (West Supp. 1979).

168. In proposing that the Bankruptcy Reform Act continue to defer exclusively to non-bankruptcy exemption law, the Senate noted the abuse which might be possible through split choice of exemptions by debtors in a joint case if the Act provided for choice of exemptions as suggested in H.R. 8200.

*Avoidance of pre-petition transfers.* Title 11 also empowers the debtor to avoid certain pre-petition transfers of property of the debtor which the debtor might have exempted had the transfer not been made<sup>169</sup> and to exempt some of the property recovered through use of the avoiding power.<sup>170</sup> These important powers, granted in section 522(f) through 522(j) of title 11, will be described in the context of the following hypothetical case history.

Mr. and Mrs. Smith and their two children, aged two and four, live in a rented three bedroom home. Mrs. Smith stays at home to care for the children and Mr. Smith earns enough money from his job to pay basic monthly living expenses, a monthly car payment, a monthly payment to a finance company, and \$75 per month for other outstanding bills. Several months ago the financial affairs of the Smith family were disrupted by an unexpected and uninsured hospital expense, exceeding \$13,000, incurred for emergency medical treatment of their youngest child. The Smiths were unable to pay the hospital and the debt was assigned for collection to a collection agency. A financial crisis was precipitated by the following recent action of the collection agency to enforce its judgment: the sale, two weeks ago,<sup>171</sup> of Mr. Smith's 1974 half-ton Chevro-

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Such a provision in joint cases would result in a husband choosing State exemptions while a wife might choose Federal exemptions. Together, they could thus retain after bankruptcy, very substantial amounts of property, while their debts would have been discharged. The committee feels that the policy of the bankruptcy law is to provide a fresh start, but not instant affluence, as would be possible under the provisions of H.R. 8200.

SENATE REPORT, *supra* note 114, at 6, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5792. When the compromise on section 522(b) was reached between Senate and House, *see* text accompanying note 123 *supra*, the language of the compromise did not address this concern. From the language of the Senate Report and from the fact of the compromise one might infer an intent to allow a limited state prohibition such as that described in the text.

169. "Transfer" is defined broadly in section 101(40) of title II to include: "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest." 11 U.S.C.A. § 101(40) (West Spec. Pamp. 1979). A pre-petition transfer would thus include the creation of a security interest in property to secure repayment of an obligation as well as a simple cash payment to a creditor in partial or complete satisfaction of a pre-existing indebtedness.

170. The procedure for exercise of these powers is to be specified in the Bankruptcy Rules. HOUSE REPORT, *supra* note 114 at 297, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6254.

171. For purposes of ensuing discussion in the text it should be assumed that all time periods specified in the hypothetical case are to be considered as time periods antedating the filing of a petition.

let pick-up, following levy of a writ of execution two months ago; the recording of an abstract of judgment affecting, and thus creation of a lien upon,<sup>172</sup> some undeveloped mountain real property (valued at \$4,500) owned by Mr. and Mrs. Smith which they had expected to retain for future construction of a retirement cabin; the threat by the collection agency to begin garnishing Mr. Smith's wages.

The total outstanding obligations of Mr. and Mrs. Smith are:

Bank of America		\$ 2,500.
(holds pink slip to Ford)		
Credit Cards		\$ 995.
Visa	\$250.	
Mastercharge	\$180.	
Bullocks	\$370.	
Texaco	\$ 75.	
American Express	\$120.	
Finance Company		\$ 3,000.
(secured by household goods)		
Hospital, assigned for collection		\$13,249.
Mr. Smith's brother		\$ 800.
Pediatrician		\$ 475.
Dentist		\$ 380.
	Total:	\$21,399.

Mr. and Mrs. Smith's assets consist of household furnishings (collateral for a non-purchase money secured loan from the finance company), wearing apparel, a small sum in a savings and loan account, camera equipment, sporting goods, a 1976 Ford (obtained with the proceeds of a purchase money secured loan made by the Bank of America), and the undeveloped real property now subject to lien. In addition, five months ago, Mr. and Mrs. Smith used a \$700 tax refund to partially repay Mr. Smith's \$1,500 debt to his brother. Mr. and Mrs. Smith have been making minimum payments on their credit card obligations for the past year.

Under section 522(f) through 522(j) of title 11, the liens on the undeveloped real property and household furnishings and the execution sale of the Chevrolet half-ton pick-up may be avoided and these items of property claimed exempt. The payment to Mr. Smith's brother may be avoided but the funds recovered may not be claimed exempt. The Ford automobile may be redeemed from the bank's lien by the Smith's payment

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172. CAL. CIV. PROC. CODE § 674 (West Supp. 1979).

to the bank of the automobile's fair market value. Some of the payments on credit card obligations might or might not be avoidable; if avoided, funds recovered could not be claimed exempt.

Pursuant to section 522(f), Mr. and Mrs. Smith may avoid the fixing of a judicial lien upon their interest in the undeveloped real property to the extent that the lien impairs an exemption to which they otherwise would have been entitled had the lien not been created.<sup>173</sup> This would be true even if the fixing of the lien were not a preferential transfer;<sup>174</sup> under section 522(f), a judicial lien may be avoided no matter how long the fixing of the lien antedates the filing of a petition. Thus, for example, a lien on real property arising ten years previous to the filing of a petition could be avoided by the debtor if that real property could otherwise be exempted under section 522(b). Since Mr. and Mrs. Smith do not own real property which they use as a residence, it would be advisable for them to claim the section 522(d) exemptions, entitling each of them to a "grubstake" exemption of \$7,900.<sup>175</sup> By so doing, they may claim the undeveloped real property exempt. Given that choice of exemptions under section 522(b), the lien on the undeveloped real property impairs an exemption to which they would be entitled under section 522(b) and thus, under section 522(f)(1), the lien may be avoided.<sup>176</sup>

The power of the debtor to avoid judicial liens on otherwise exemptable property poses some interesting questions when considered in the context of California's declared homestead and claimed residential exemption law.<sup>177</sup> To depart briefly

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173. 11 U.S.C.A. § 522(f)(1) (West Spec. Pamp. 1979) reads:

Notwithstanding any waiver of exemptions the debtor may avoid the fixing of a lien on an interest of the debtor in such property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is — (1) a judicial lien . . . .

174. Under section 547 of the Bankruptcy Reform Act, the fixing of a lien upon property of the debtor within ninety days of the filing of the petition (or within one year of the filing of the petition if the judgment creditor is an insider with respect to the debtor) may constitute a voidable preference. *Id.* § 547(b). Section 547 accomplishes in one section what the Bankruptcy Act of 1898 accomplished in section 60 (voluntary transfers) and 67a (involuntary transfers). Bankruptcy Act of 1898, ch. 541, §§ 60, 67a, 30 Stat. 562, 564 (as amended) (formerly 11 U.S.C. §§ 96, 107a (1976)).

175. See text following note 146 *supra*.

176. Presumably the new Bankruptcy Rules will prescribe the appropriate procedure to avoid the lien. See note 131 *supra*.

177. CAL. CIV. CODE §§ 1237-1304 (West 1954 & Supp. 1979); CAL. CIV. PROC. CODE § 690.31 (West Supp. 1979).

from the given hypothetical, suppose that Mr. and Mrs. Smith owned a home and that their equity in the home was \$30,000. If Mr. and Mrs. Smith had recorded a Declaration of Homestead for that property following a judgment creditor's recordation of an abstract of judgment, the lien resulting from recordation of the abstract would impair their homestead exemption.<sup>178</sup> Thus, under section 522(f)(1), the lien could be avoided if, as would be advisable, the Smiths chose to rely on non-bankruptcy exemptions. Suppose, however, that the Smiths had not recorded a Declaration of Homestead but rather had intended to rely upon California's claimed residential exemption.<sup>179</sup> The recorded abstract of judgment would still constitute a lien on their residence but it would arguably not impair an exemption to which they would otherwise be entitled.<sup>180</sup> If the lien does not impair an exemption, the lien may not be avoided under section 522(f)(1). Thus, by virtue of the strange nature of California's presently existing exemption scheme for real property used as a residence, it is possible that a lien which, under the homestead law, is superior to a debtor's claim of exemption can be avoided in bankruptcy but a lien which, under the claimed residential exemption, is subordinate to the debtor's claim of exemption cannot be avoided.

Mr. and Mrs. Smith would also be entitled to avoid the lien of the finance company on their household goods. Section 522(f)(2) empowers the debtor to avoid all non-purchase money non-possessory security interests in household goods, tools of the trade, and health aids.<sup>181</sup> This power strikes directly at the

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178. Recordation of an abstract of judgment prior to recordation of a Declaration of Homestead would create a lien on the property, *see* note 24 *supra*, and that lien would take priority over the debtor's claim of exemption under the homestead provisions. CAL. CIV. CODE § 1241(4) (West 1954 & Supp. 1979).

179. CAL. CIV. PROC. CODE § 690.31 (West Supp. 1979).

180. The abstract would constitute a lien on the property despite the claim of exemption, *id.* § 674(c) (West 1955 & Supp. 1979), but the lien would arguably not impair the exemption because the lien is subordinate to the debtor's claim of exemption under CAL. CIV. PROC. CODE § 690.31(j) (West Supp. 1979). It is unclear whether this state law subordination of a lien means that the lien does not impair an exemption. One might argue that the lien does impair the exemption despite its subordination to the exempt amount in a forced sale, because upon voluntary sale of the property by the debtor the lien would in effect reduce the amount paid to the debtor as proceeds of the sale. Unlike the case of the homestead exemption, the exempt amount under the claimed residential exemption is not protected in the event of voluntary sale of the property. *Id.* § 690.31(k).

181. More precisely, the lien which is avoidable under section 522(f)(2) is a lien on items of property which are described in sections 522(d)(3), 522(d)(6), and 522(d)(9) of title 11. 11 U.S.C.A. § 522(f)(2) (West Spec. Pamp. 1979). The debtor need not claim

standard finance company practice of securing non-purchase money loans with security interests in household goods and furnishings. Congress correctly perceived that finance companies insist upon such collateral primarily for leverage and not as meaningful security because actual repossession of second hand furnishings (or tools or health aids) rarely nets the creditor sufficient funds to repay the loan. The threat of repossession, however, frequently coerces the debtor into reaffirmation of debt after bankruptcy because the debtor's cost of replacing the items is high.<sup>182</sup> Title 11 sets strict limits elsewhere on the ability of debtors to reaffirm debts after the filing of a petition;<sup>183</sup> section 522(f)(2) provides even further protection against reaffirmation by invalidating the primary leverage by which a reaffirmation of a debt to a finance company is induced.<sup>184</sup> It will be interesting to observe whether this new avoiding power will decrease the availability of consumer credit extended by finance companies or lead to pressure by finance companies upon legislators to raise interest rate ceilings.<sup>185</sup>

It should be emphasized that section 522(f)(2) does not permit the debtor to avoid purchase money security interests<sup>186</sup>

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section 522(d) exemptions, however, to take advantage of section 522(f)(2) as long as the non-bankruptcy exemptions chosen by the debtor include the kinds of property to which section 522(f)(2) refers.

182. See *House Hearings*, *supra* note 8, at 761-62, 946, 960 (testimony of David Williams, Counsel, Division of Special Projects, Bureau of Consumer Protection, Federal Trade Commission; testimony of Ernest L. Sarason, Jr., Staff Attorney, The National Consumer Law Center, Inc.; and testimony of Linn K. Twinem, General Counsel, Beneficial Finance Co.).

183. See text accompanying notes 291-303 *infra*.

184. It was a standard practice of finance companies in cases under the Bankruptcy Act to contact the bankrupt shortly after the debtor filed a petition, often at the first meeting of creditors, to ask that the debtor make arrangements to reaffirm part or all of the existing secured indebtedness. Frequently, the contact was initiated by a question such as: "Are you going to reaffirm the debt or are we going to have to repossess your furniture?" If well counseled, the debtor was usually able to negotiate a reaffirmation of the debt for no more than the fair market value of the collateral because the creditor would get no more than that amount by repossession in any event. Contrast the practice of certain motor vehicle secured lenders described in note 296 *infra*.

185. Finance companies may argue that inability to seek reaffirmation through the leverage of security will lead to increased operating losses resulting from default and that extension of credit, therefore, must be restricted or that higher interest rates must be charged to compensate for such losses. See *House Hearings*, *supra* note 8, at 903.

186. For example, a debtor could not avoid a security interest in a refrigerator the purchase of which was financed by a loan from a finance company. Congress was urged to permit avoidance of purchase money security interests. See *House Hearings*, *supra* note 8, at 940.



and does not permit the debtor to avoid any security interest, whether or not purchase money, in an automobile (unless the automobile is a tool of the trade). These limits to the avoiding power may induce a change in the pattern of finance company loans to consumers or prompt finance companies to seek a security interest in automobiles more frequently.

Finance companies are likely to mount a due process challenge to section 522(f)(2), claiming that its implementation constitutes a taking of property (avoidance of a security interest) without due process of law. Such a challenge will probably fail in view of broad congressional power to implement the constitutional grant of authority to enact uniform laws respecting bankruptcy and because the value of the property taken is, on the whole, *de minimus*.<sup>187</sup>

Section 522(f) provides only that the debtor may *avoid* certain transfers. It does not by itself give the debtor the power to exempt property the transfer of which has been avoided. Subsections 522(i) and 522(j)<sup>188</sup> grant that specific power by stating that the debtor may exempt such property (subject to the limitations of section 550),<sup>189</sup> but only to the extent that the debtor has exempted less property in value of such kind than that to which the debtor is entitled under section 522(b). Thus, in the given hypothetical for example, if Mr. and Mrs. Smith owned another asset valued at \$14,000 and had thus otherwise each "used" \$7,000 of their \$7,900 "grubstake" exemption, they would each be entitled to claim exempt only \$900 more

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187. U.S. CONST. art. I, § 8, cl. 4 empowers Congress to establish uniform laws on the subject of bankruptcy. Although Congress is not limited by the constitutional proscription against impairment of the obligation of contracts, *id.* art. I, § 10 (prohibits *states* from impairing obligation of contracts), Congress is nevertheless bound by fifth amendment due process standards. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1934) (invalidating Frazier-Lemke Act abridging rights of mortgagees). Under these standards, bankruptcy legislation will be upheld unless the challenged provisions are "so grossly arbitrary and unreasonable as to be 'incompatible with fundamental law.'" *Campbell v. Alleghany Corp.* 75 F.2d 947, 953 (4th Cir.), *cert. denied*, 296 U.S. 581 (1935) (quoting *Hanover Nat'l Bank v. Moyses*, 186 U.S. 181, 192 (1901)) (upholding "cram down" corporate reorganization provisions of Bankruptcy Act before Chandler Act amendments). In view of the well considered purposes of the relief afforded by section 522(f)(2), discussed in the text, the section would appear to withstand constitutional scrutiny applying these standards.

188. 11 U.S.C.A. § 522(i) - (j) (West Spec. Pamp. 1979).

189. Section 550 of the Bankruptcy Reform Act describes the liability of a transferee of an avoided transfer. Under that section, neither the trustee nor the debtor could recover property or the value of such property from certain good faith transferees of the initial transferee of an avoidable transfer. *Id.* § 550.

in value of the undeveloped real property.<sup>190</sup>

If Mr. and Mrs. Smith had filed their joint petition prior to the forced sale of the Chevrolet half-ton pick-up, they might in that case also have been able to invoke section 522(f)(1) to avoid the lien of the collection agency which had arisen by virtue of the levy of the writ of execution.<sup>191</sup> Assuming, however, as the hypothetical case postulates, that the lien had already been extinguished by sale,<sup>192</sup> section 522(f)(1) would not be availing because there would no longer be a lien to avoid at the time of the filing of the petition. There would be other grounds, however, for avoiding the transfer (of the proceeds of the forced sale to the collection agency in partial satisfaction of its claim) and provision is made for the debtor to exempt the property thus regained for the estate.

The hypothetical case postulates that the collection agency's lien on the automobile arose two months prior to the filing of the petition.<sup>193</sup> Under those circumstances, the creation

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190. If the debtors could not exempt the full value of the property subject to the lien, the lien may be avoided only "to the extent that [it] impairs an exemption to which the debtor would have been entitled under subsection (b) of this section." *Id.* § 522(f). It is not clear whether this language means that the amount of the debt secured by the lien is reduced by the amount of the exemption that is impaired by the lien or, rather, that the lien remains to the full extent of the debt but is subordinated to the debtor's exemption. For example, assume that a piece of real property valued at \$10,000 is subject to a judicial lien securing a debt of \$9,000 and that this lien impairs a debtor's exemption to the extent of \$2,500. If the "avoid" language of section 522(f) means that the debt secured by the lien is reduced in the amount by which the exemption is impaired, the property would be sold by the trustee and the proceeds would be distributed \$2,500 to the debtor, \$6,500 to the lien creditor (\$9,000 reduced by \$2,500) and \$1,000 to the trustee. If the "avoid" language means that the lien remains to the full extent of the debt but is subordinated to the debtor's exemption, the trustee would not be able to sell the property and the lien creditor would benefit from any subsequent appreciation in the value of the property; if the debtor subsequently sold the property for \$15,000, the lien creditor would realize the full amount of its \$9,000 judgment. This latter interpretation would appear to be consistent with analagous treatment given to judicial liens on residential real property in California (where no declaration of homestead has been filed), CAL. CIV. PROC. CODE § 674(c) (West Supp. 1979), but there is certainly no reason to suspect that the drafters of the Bankruptcy Reform Act were thinking of that California law when choosing the language of section 522(f).

191. Levy of a writ of execution creates a lien on the property on which levy is made. CAL. CIV. PROC. CODE § 688 (West 1955 & Supp. 1979). 11 U.S.C.A. § 101(27) (West Spec. Pamp. 1979) defines judicial lien to include a lien through levy of execution. Such a judicial lien could be avoided under the terms and to the extent provided in section 522(f)(1).

192. Sale under a writ of execution extinguishes the lien created by the levy. *Fry v. Bihr*, 6 Cal. App. 3d 248, 257, 85 Cal. Rptr. 742, 743 (1970); *Haskins v. Certified Escrow & Mortgage Co.*, 96 Cal. App. 2d 688, 691, 216 P.2d 90, 93 (1950).

193. See note 171 and accompanying text *supra*.

of the lien would most probably constitute a preferential transfer avoidable by the trustee under section 547 of title 11.<sup>194</sup> If avoidable by the trustee under section 547, the debtor may benefit by the trustee's avoidance of the transfer, or the debtor may himself undertake to avoid the transfer if the trustee fails to act. Almost never will the trustee act to avoid pre-petition transfers of property which the debtor could claim entirely exempt because the trustee would have no financial incentive to do so.<sup>195</sup> If, however, the debtor has transferred property of substantial value only some of which the debtor could exempt once recovered by the trustee, the trustee might act to avoid the transfer.<sup>196</sup> In that event, the debtor, under section 522(g),<sup>197</sup> will be entitled to exempt such property as is recovered by the trustee but, again, only to the extent allowed by section 522(j),

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194. 11 U.S.C.A. § 547 (West Spec. Pamp. 1979). It is clearly important for the consumer insolvency counselor to be conversant with the avoiding powers of the trustee, especially so under the Bankruptcy Reform Act because the debtor's rights to exempt property transferred prior to the petition in large part rest upon the avoiding powers of the trustee. The lien described in the text would be an avoidable transfer under section 547, because it meets all of the conditions of section 547(b) and is not an excepted (*i.e.* non-avoidable) transaction under section 547(c). *Id.*

195. Under section 330 of the Bankruptcy Reform Act, the trustee is to be paid \$20 for serving in a case under Chapter 7, together with "reasonable compensation for actual, necessary services rendered by such trustee" and "reimbursement for actual, necessary expenses." *Id.* § 330(a)-(b). However, compensation for services rendered in a case under Chapter 7 is limited by section 326 to declining fixed percentages applied to "all moneys disbursed or turned over in the case by the trustee to parties in interest, *excluding* the debtor, but including holders of secured claims." *Id.* § 326(a) (emphasis added). The trustee would thus earn nothing for his or her services if the property recovered were entirely exempt and would have to be turned over to the debtor. Creditors would not suffer by trustee inaction in such a case because the property could be claimed exempt by the debtor.

196. Suppose, for example, that property of the debtor valued at \$15,000 had been lost by the debtor at an execution sale preceding the filing of the petition. If the trustee could avoid that transfer and if the debtor could exempt \$7,900 in value of such property under section 522(d)(5), the trustee would have available (expenses for recovery of the property aside) \$7,100 for disbursement to creditors. Under section 326, the trustee would be entitled to compensation not exceeding \$393 for his or her efforts in recovering the property. *Id.* § 326(a).

197. 11 U.S.C.A. § 522(g) (West Spec. Pamp. 1979) reads:

- Notwithstanding sections 550 and 551 of this title, the debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if —
- (1)(A) such transfer was not a voluntary transfer of such property by the debtor; and
  - (B) the debtor did not conceal such property; or
- (2) the debtor could have avoided such transfer under subsection (f)(2) of this section.

that is, only to the extent that the debtor has exempted less property in value of such kind than that to which the debtor is entitled under section 522(b).<sup>198</sup>

If the trustee fails to act, however, the debtor may invoke section 522(h) to avoid certain transfers which the trustee could have avoided.<sup>199</sup> If the trustee fails to seek to regain the proceeds of the execution sale of the automobile, Mr. Smith may do so because, under section 522(h), which refers to section 522(g)(1), the transfer was not a voluntary transfer and Mr. Smith had not concealed the property. Similarly, and of great practical importance, any debtor could recover wages the pre-petition garnishment of which constitutes a preferential transfer to the garnishing creditor.

Mr. Smith could not accomplish this same result to recover and exempt the moneys paid to his brother in partial satisfaction of a pre-existing indebtedness. That payment, too, would probably constitute an avoidable preferential transfer but, if the trustee fails to set aside that transfer, Mr. Smith would not be able to recover the payment because the transfer was voluntary.<sup>200</sup>

Neither the trustee nor Mr. Smith would be able to recover payments made on credit card obligations during the months preceding the filing of the petition, although this conclusion is not entirely certain. Section 547(c)(2) provides that the trustee may not avoid a transfer of property (otherwise preferential under section 547) if the transfer was in payment of a debt incurred in the ordinary course of the financial affairs of the debtor and transferee, was made not more than forty-five days after the debt was incurred, and was made in the ordinary course of the financial affairs of the debtor and according to ordinary business terms.<sup>201</sup> The legislative history concerning this exception from the trustee's power to avoid preferences refers specifically to the payment of utility bills and suggests

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198. See text accompanying notes 188-89 *supra*.

199. 11 U.S.C.A. 522(h) (West Spec. Pamp. 1979) reads:

The debtor may avoid a transfer of property of the debtor or recover a set off to the extent that the debtor could have exempted such property under subsection (g)(1) of this section if the trustee had avoided such transfer, if - (1) such transfer is avoidable by the trustee under section 544, 545, 547, 548, 549, or 724(a) of this title or recoverable by the trustee under section 553 of this title; and

(2) the trustee does not attempt to avoid such transfer.

200. *Id.*

201. *Id.* § 547(c)(2).

that other similar payments to creditors which do not bear the indicia of rapid pre-bankruptcy dissipation of the estate should not be subject to the avoiding power.<sup>202</sup> Accordingly, it would seem that payment on credit card obligations within forty-five days of incurring the debt will not be an avoidable transfer. It is doubtful, in any event, that the issue will be frequently presented because most debtors seeking insolvency counseling will not have been making such timely payments.

The foregoing discussion serves to indicate the importance to effective bankruptcy planning of evaluating the nature, extent and timing of the debtor's pre-petition transfers and the importance of understanding the trustee's avoiding powers. Section 522(f) through 522(j) provide significant additional tools with which to protect property for the debtor's post-petition fresh start.

*Retroactive application of increases in dollar amounts of exemptions.* Creditors have long insisted and, until recently, usually convinced judges, that increases in the dollar amount of exemptions should not, and constitutionally cannot, apply retroactively to creditors whose claims arose prior to the effective date of the increase.<sup>203</sup> The constitutional argument has been grounded in article I, section 10 of the United States Constitution<sup>204</sup> which precludes any state from impairing the obligation of contract. In California, *In Re Rauer's Collection Co.*,<sup>205</sup> *England v. Sanderson*,<sup>206</sup> and, more recently, *Daylin Medical and Surgical Supply, Inc. v. Thomas*<sup>207</sup> and *Swenor*

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202. SENATE REPORT, *supra* note 114, at 88, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5874; HOUSE REPORT, *supra* note 114, at 373-74, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6329-30.

203. See, e.g., *In re Messinger*, 29 F.2d 158, 161 (2d Cir. 1978); *In re Rechtman*, 11 F. Supp. 347, 350-51 (E.D.N.Y. 1935); *In re Marx*, 5 F. Supp. 954, 955 (E.D. La. 1916). See generally Comment, *The Contract Clause and the Constitutionality of Retroactive Application of Exemption Statutes: A Reconsideration*, 9 PAC. L.J. 889 (1978); Comment, *Contracts Clause Prevents Exemption Change*, 1 STAN. L. REV. 350 (1949).

204. U.S. CONST. art. I, § 10, cl. 1 states: "No State shall . . . pass any . . . law impairing the Obligation of Contracts . . ." This language is substantially the same as that in CAL. CONST. art. I, § 16, and the clauses in both constitutions are construed identically by California courts. *Birkhofer v. Krum*, 27 Cal. App. 2d 513, 81 P.2d 609 (1938), with deference to the controlling construction of the federal courts. *Id.* at 536, 81 P.2d at 621.

205. 87 Cal. App. 2d 248, 196 P.2d 803 (1948).

206. 236 F.2d 641 (9th Cir. 1956), *rev'g In re Sanderson*, 134 F. Supp. 484 (N.D. Cal. 1955).

207. 69 Cal. App. 3d Supp. 37, 137 Cal. Rptr. 826 (1977).

*v. Robertson*<sup>208</sup> have articulated and applied the constitutional argument. Description and analysis of *Swenor*, the most recent published bankruptcy opinion on the question, will provide a useful starting point for considering the present and future resolution of this important question.

Mr. and Mrs. Swenor filed a voluntary petition on March 17, 1977, two and one half months after the effective date of the then latest increase in the amount of the California homestead exemption (from \$20,000 to \$30,000 for head of household). The Swenors claimed \$30,000 in value of their home exempt; the trustee was willing to allow only \$20,000 in value exempt. In litigation on the issue, the parties stipulated that the claims of some of the Swenor's creditors arose prior to the effective date of the increase in the homestead exemption. On appeal from the decision of the Bankruptcy Judge in favor of the Swenors, the District Court for the Northern District of California, relying on *In Re Rauer's Collection Co.*, articulated a compromise position which rested on the accepted constitutional principle that increases in exemptions could not be applied retroactively.<sup>209</sup>

Departing from *England v. Sanderson*, decided by the Ninth Circuit in 1956, the court held that the trustee was not entitled to assert the position of such pre-increase creditors under section 70c of the Bankruptcy Act<sup>210</sup> because that section only entitled the trustee to assert the position of a hypothetical creditor who was deemed to extend credit to the bankrupt and obtain a lien with respect to such credit on the date of the filing of the petition, a time clearly *after* the increase in the amount of the exemption.<sup>211</sup> The court suggested that it was not bound by a contrary conclusion in *England v. Sanderson*<sup>212</sup> because that decision relied, in part, upon the Second Circuit's 1954 interpretation of section 70c in *Constance v. Harvey*,<sup>213</sup> a case overruled by the United States Supreme Court in *Lewis v. Manufacturer's National Bank of Detroit*.<sup>214</sup>

Since the trustee did not have the power, under section 70c

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208. 452 F. Supp. 673 (N.D. Cal. 1978).

209. *Id.* at 678.

210. Bankruptcy Act of 1898, ch. 541, § 70c, 30 Stat. 566 (as amended) (formerly 11 U.S.C. § 110 (1976)).

211. 452 F. Supp. at 676-77.

212. *Id.* at 676.

213. 215 F.2d 571 (2d Cir. 1954), *cert. denied*, 348 U.S. 913 (1955).

214. 364 U.S. 603 (1961).

or under any other section of the Bankruptcy Act, to assert the position of pre-increase creditors, the court recognized what amounts to something like a common law power in the trustee which would protect the interests of such creditors against the increase in the amount of the exemption without unduly delaying the administration of the bankrupt's estate.<sup>215</sup> The court held that the claims of pre-increase creditors should be aggregated and that the total of their claims (not to exceed the difference between the old and new exemption amounts) should be subtracted from the higher exemption amount (in the *Swenor* case, from \$30,000) to arrive at the amount of the Swenor's exemption. Any equity in the home exceeding that amount was then to be distributed to all creditors of the bankrupts.<sup>216</sup>

The developing case law in other jurisdictions, and recent case law in California, would support the overruling of *In Re Rauer's Collection Co.* and its progeny, upon which the court relied in *Swenor v. Robertson*.<sup>217</sup> Cases in other jurisdictions

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215. 452 F. Supp. at 677-78.

216. *Id.* at 678.

217. Recent California decisions upholding the retroactive application of community property and sovereign immunity laws have invoked due process analysis. *In re Marriage of Bouquet*, 16 Cal. 3d 583, 546 P.2d 1371, 128 Cal. Rptr. 427 (1976) (community property); *Robertson v. Willis*, 77 Cal. App. 3d 358, 367-69, 143 Cal. Rptr. 523, 527-30 (1978) (community property); *Fluornoy v. State of Cal.*, 230 Cal. App. 2d 520, 530-31, 41 Cal. Rptr. 190, 196-201 (sovereign tort immunity of public entities). These cases have applied a balancing approach to determine whether retroactive application of a statute transgresses the bounds of due process. As announced by the California Supreme Court in *Bouquet*:

In determining whether a retroactive law contravenes the due process clause, we consider such factors as the significance of the state interest served by the law, the importance of the retroactive application of the law to the effectuation of that interest, the extent of reliance upon the former law, the legitimacy of that reliance, the extent of actions taken on the basis of that reliance, and the extent to which the retroactive application of the new law would disrupt those actions.

16 Cal.3d at 592, 546 P.2d at 1376, 128 Cal. Rptr. at 432.

If the *Bouquet* due process criteria were applied to test the constitutionality of applying exemption statutes retroactively, the balance of interests would seem to favor permitting retroactive application. Comment, *The Contract Clause and the Constitutionality of Retroactive Application of Exemption Statutes: A Reconsideration*, *supra* note 203, at 909-19. Traditionally, however, California courts have not applied this balancing approach in assessing the constitutionality of retroactive application of increases in exemption amounts. See, e.g., *Daylin Medical Surgical Supply, Inc. v. Thomas*, 69 Cal. App. 3d Supp. 37, 138 Cal. Rptr. 878 (1977). "The cases cited by the plaintiff all stand for the general proposition that statutes cutting down the creditor's rights by granting the debtor exemptions, in the absence of an emergency situation (such as great depression) are unconstitutional as an impairment of contractual obligations." *Id.* at 41, 138 Cal. Rptr. at 880.

permitting retroactive application of increases in exemption amounts emphasize that the creditor's interest in protecting the obligation of contract must be balanced against the interests of debtors in exempting property for a fresh start. Decisions in these cases have struck the balance in favor of debtors because most creditors do not, in fact, rely upon an existing dollar amount of exempt property when extending credit (and their contract could not then realistically be said to be impaired) and because debtors, squeezed by inflation, require increased amounts of property for a fresh start. Consistent with this balancing approach, the cases do not articulate a *per se* rule of retroactivity. Rather, they appear to articulate a rule allowing retroactivity unless the impairment is extreme; increases to keep pace with inflation would thus probably pass constitutional muster while exemption of an entirely new kind of property, in large amounts, might not.<sup>218</sup>

If, then, a California state court or a federal court interpreting California law determine to articulate a new constitutional principle in this area, the compromise position articulated in *Swenor v. Robertson* will be history and debtors will be entitled to choose non-bankruptcy exemptions in amounts permitted by non-bankruptcy law as of the date of the filing of the petition.<sup>219</sup>

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This literal approach to contract clause analysis ignores the "softening" of the United States Supreme Court's approach to the issue since *Home Bldg. & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934), and a substantial body of authority which suggests that "the standard of reasonableness under the contract clause is the same as that utilized in determining the validity of retrospective legislation under the due process clauses. . . ." Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692, 695 & n.19 (1960). See also *United States Trust Co. v. New Jersey*, 431 U.S. 1, 12-23 (1977); *City of El Paso v. Simmons*, 379 U.S. 497, 515-16 (1965). This authority strongly suggests that the *per se* approach inherited from *In re Rauer's Collections Co.* is incorrect and that a balancing approach, applying the due process standard of reasonableness, is appropriate.

Cases in Louisiana and Oregon have adopted a balancing approach to sustain the constitutionality of applying increases in exemption amounts retroactively. *Wilkinson v. Carpenter*, 277 Or. 557, 561 P.2d 607 (1977) (amount of homestead exemption to be determined at time of levy followed by claim of exemption rather than at time judgment obtained); *Hooter v. Wilson*, 273 So. 2d 516, 522 (La. 1973); *accord*, *Oachita Nat'l Bank v. Rowan*, 345 So. 2d 1014 (La. Ct. App. 1977); *Natchitoches Collections, Inc. v. Gorum*, 274 So. 2d 449 (La. Ct. App. 1973).

218. See note 217 *supra*.

219. Consistent with the developments described in note 217 *supra*, the California Law Revision Commission Staff has proposed in its tentative recommendation relating to California's enforcement of judgment law that the existence or amount of an exemption be determined pursuant to the exemption statutes in effect at the time the claim of exemption is made. COMM'N TENTATIVE RECOMMENDATION, *supra* note 22,



Under title 11, of course, a debtor may not choose non-bankruptcy exemptions but rather may choose section 522(d) exemptions. In that case too, a debtor should be able to benefit from the full value of the section 522(d) exemptions (including amounts subsequently substituted under section 104)<sup>220</sup> even though the debtor may have incurred obligations prior to the effective date or even the enactment date of the Bankruptcy Reform Act (or prior to the effective date of increases pursuant to section 104). Title 11 does not state that section 522(d) exemptions will apply retroactively to creditors whose claims predate the enactment or effective date of the Act, (or an increase pursuant to section 104). However, courts faced with the issue should permit retroactive application for the reasons discussed above and probably will permit retroactive application both because the constitutional prohibition against impairment of contract only limits state action and because Congress appears to have the power to make such exemptions retroactive despite the limitations imposed by the fifth amendment due process clause.<sup>221</sup>

The foregoing discussion has suggested the plasticity of bankruptcy exemption law and its crucial importance to competent insolvency counseling. Indeed, title 11 provides some

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at 232. If this recommendation became law and withstood constitutional attack, a debtor in a case under title 11, filing in California, who chose to claim non-bankruptcy exemptions, would be entitled to exemptions provided by California law in the amounts provided by exemptions statutes in effect at the time the petition is filed, because section 522(b)(2) of title 11 provides that an individual debtor may exempt from the property of the estate "any property that is exempt under Federal law . . . , or state or local law that is applicable on the date of the filing of the petition." 11 U.S.C.A. § 522(b)(2) (West Spec. Pamp. 1979).

The state law "applicable on the date of the filing of the petition" need not necessarily permit full retroactive application of increases in exempt amounts. For example, the current amount of the California homestead exemption can be claimed only "to the extent that such increase [from \$30,000 to \$40,000 for the head of a family effective January 1, 1979] does not impair or defeat *the right of any creditor to execute upon the property which existed prior to such date [when the increase became effective].*" CAL. CIV. CODE § 1260 (West Supp. 1979) (emphasis added). Thus, a state may provide that the determination of the amount of an exemption shall be made at the time a creditor's claim arises (no retroactivity), or at the time the creditor obtains a lien on the property claimed exempt (partial retroactivity), or at the time the debtor claims the exemption (full retroactivity). The proposal from the staff of the California Law Revision Commission is thus but one possible choice concerning the extent to which increase in exempt amounts shall be retroactive. Therefore, even if the constitutional hurdle is surmounted, one need be alert to developments under state law (legislation or case law) which will determine the extent to which increases in exempt amounts are to be applied retroactively.

220. See text accompanying note 139 *supra*.

221. See note 187 and accompanying text *supra*.

significantly different answers to the debtor's inquiry about property which can be retained for the debtor's post-petition fresh start. There remains to be considered the answers to the debtor's inquiry about the kinds and amounts of debt which the bankruptcy will lift from the debtor's shoulders.

### *Discharge and Dischargeability*

Provisions of title 11 governing discharge and dischargeability do not alter the contours of consumer insolvency counseling to the same extent as provisions governing exemptions or provisions governing reaffirmations or redemptions.<sup>222</sup> As a consequence, the description here of discharge and dischargeability under title 11 will be more a sketch of adjustments and refinements than a portrait of major revisions.

Title 11 preserves the distinction drawn by sections 14 and 17 of the Bankruptcy Act of 1898 between the debtor's general discharge from debts and the debtor's continuing liability for particular kinds of debts notwithstanding the general discharge. Section 727 of title 11 roughly parallels section 14 of the Bankruptcy Act; it requires the bankruptcy court to grant the (individual)<sup>223</sup> debtor a discharge unless the court finds that one of ten grounds for denial of discharge exists. Section 727 also states the time in which and the conditions under which a discharge may be revoked. Section 523, like section 17 of the Bankruptcy Act, lists debts which are to be excepted from any discharge and circumscribes the procedure for litigating the dischargeability of certain of those debts. Sections 524 and 525 describe the effect of a discharge in somewhat greater detail than does section 14 of the Bankruptcy Act and section 524 mandates a new procedure, the discharge hearing, which is intended to help safeguard the uninformed debtor against post-petition pressures from creditors and to impress upon the debtor the solemnity of the bankruptcy proceedings.

### *Discharge*

For the most part the grounds for denial of discharge under section 727(a) track those in section 14 of the Bankruptcy

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222. Reaffirmation and redemption are discussed in the text accompanying notes 291-303 *infra*.

223. Section 727, unlike section 14 of the Bankruptcy Act, allows a discharge only to an individual debtor and not to a corporation or partnership. 11 U.S.C.A. § 727(a)(1) (West Spec. Pamp. 1979).

Act.<sup>224</sup> These include transfer, destruction, or concealment of property, within the year preceding the filing of a petition, with the intent to defraud creditors,<sup>225</sup> concealment, destruction or falsification of books and records reflecting the debtor's financial position,<sup>226</sup> failure to satisfactorily explain any loss of assets of the debtor,<sup>227</sup> and failure to obey lawful orders of the court.<sup>228</sup>

In addition, under section 727(a)(7), a debtor will be denied a discharge if he or she has committed any act specified in sections 727(a)(2) through (a)(6) in connection with a case concerning an insider.<sup>229</sup> Thus, for example, a debtor will be denied a discharge if it be determined that within one year preceding the filing of the debtor's petition he or she concealed, destroyed or falsified books or records necessary to ascertain the financial condition of the debtor's brother who had previously filed a petition in bankruptcy. This additional ground for denial of discharge obviously penalizes persons who assist or cooperate with others in frustrating the purposes of bankruptcy law.

Section 727(a)(8) continues to prohibit a debtor from obtaining a discharge in a liquidation more than once every six years.<sup>230</sup> Section 727(a)(9), however, permits the debtor a discharge in a liquidation notwithstanding discharge in a prior wage earner proceeding which commenced less than six years

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224. Differences between section 14 of the Bankruptcy Act and section 727 of title 11 which are not discussed in the text include: (1) Under the Bankruptcy Act of 1898, a debtor would be denied a discharge if, while engaged in business as a sole proprietor, partnership or corporate executive, the debtor obtained property or money for the business on credit by filing a false financial statement. There is no comparable provision in title 11. Compare Bankruptcy Act of 1898, ch. 541, § 14(c)(3), 30 Stat. 550 (as amended to § 14c(3)) (formerly 11 U.S.C. § 32(c)(3) (1976)) with 11 U.S.C.A. § 727 (West Spec. Pamp. 1979). Under title 11, use of a false financial statement is only grounds for excepting the specific debt from discharge. See text accompanying notes 255-66 *infra*. (2) Under the Bankruptcy Act of 1898, a debtor could be denied a discharge for refusal to pay the required bankruptcy filing fees. Bankruptcy Act of 1898, ch. 541, § 14(c)(8), 30 Stat. 550 (as amended to § 14c(8)) (formerly 11 U.S.C. § 32(c)(8) (1976)). Under title 11, failure to pay filing fees is grounds for dismissal of the case. 11 U.S.C.A. § 707(2) (West Spec. Pamp. 1979).

225. *Id.* § 727(a)(2).

226. *Id.* § 727(a)(3).

227. *Id.* § 727(a)(5).

228. *Id.* § 727(a)(6)(A).

229. *Id.* § 727(a)(7). An insider is defined in section 101(25) of title 11 to include a relative, and a relative is defined in section 101(34) of title 11. *Id.* §§ 101(25), 101(34).

230. *Id.* § 727(a)(8). To be more precise, the section prohibits the debtor from receiving a discharge in a liquidation if the petition is filed within six years of the commencement of a previous liquidation case in which the debtor was granted a discharge.

preceding the filing of the petition for liquidation, if the prior discharge followed payment in full by the debtor of allowed unsecured claims in the wage earner proceeding or payment of seventy percent of such claims where the payment plan was proposed in good faith and the plan represented the debtor's best effort.<sup>231</sup> This provision is consistent with congressional policy to preclude the development of a class of habitual bankrupts, because persons who are granted two discharges within the six year time period will either have paid all or a substantial portion of each debt dealt with in the first proceeding. In view of this new right granted to debtors to invoke the protections of bankruptcy law more than once during any six year period, it would seem incumbent upon the attorney representing a debtor in a wage earner proceeding to advise the client of the potential advantage of a composition plan and to propose such a plan for confirmation if the client desires. In the event such a plan is proposed, the attorney should seek a confirmation order finding that the plan was proposed in good faith and represented the debtor's best effort.<sup>232</sup>

### *The Effect of Discharge*

As under the Bankruptcy Act of 1898, a discharge under title 11 voids any judgment against the debtor to the extent that the judgment determines personal liability of the debtor for a dischargeable debt,<sup>233</sup> but the discharge does not affect the liability of any other person, such as a guarantor, for the debt.<sup>234</sup> The discharge also continues to operate as an injunc-

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231. *Id.* § 727(a)(9). The phrase "wage earner proceeding" is used in the text only as a shorthand reference to proceedings under Chapter XIII of the Bankruptcy Act or under Chapter 13 of title 11. See text following note 322 *infra*.

232. The Bankruptcy Rules are expected to provide for this "best effort" determination. Statement by Hon. Don Edwards (D. Cal.) upon introducing House amendment to Senate amendment in the nature of a substitute to H.R. 8200, 124 CONG. REC. H11,098 (daily ed. Sept. 28, 1978). For a fuller discussion of wage earner proceedings, see the concluding section of this article *infra*.

233. 11 U.S.C.A. § 524(a)(1) (West Spec. Pamp. 1979).

234. *Id.* § 524(d). Section 16 of the Bankruptcy Act of 1898 preserved the liability of guarantors notwithstanding the discharge of the primary obligor. Bankruptcy Act of 1898, ch. 541, § 16, 30 Stat. 550 (as amended) (formerly 11 U.S.C. § 34 (1976)). The National Consumer Law Center had urged Congress that cosigners be allowed to discharge their obligation to a creditor in connection with a bankruptcy of the primary obligor unless the creditor could "demonstrate actual and reasonable reliance upon the cosigner's ability to secure payments and the cosigner's knowing assumption of legal obligation for the debt (or else the receipt of independent consideration for his signature), . . ." *House Hearings, supra* note 8, at 943-44 (testimony of Ernest L. Sarason, Jr., Staff Attorney, The National Consumer Law Center, Inc.).

tion against the commencement or continuation of any action or employment of any process to collect a dischargeable debt.<sup>235</sup> Moreover, section 524(a)(2) of title 11 makes clear what was not explicit in the language of section 14 of the Bankruptcy Act: discharge operates as an injunction against *any* act, including extra-judicial collection efforts, by which a creditor seeks to collect debts. The discharge, then, continues in force the injunctive relief first operative upon the filing of the petition by virtue of the automatic stay.<sup>236</sup>

Section 524(a)(3) particularizes the impact of this injunction in community property states. Under California community property law, property of a debtor rather than the debtor himself or herself, is liable for payment of a debt.<sup>237</sup> In some cases, only the separate property of an individual debtor may be liable for payment of a debt;<sup>238</sup> in other cases, the community property or both the community and separate property of a debtor or the debtor's spouse may be liable for payment of a debt.<sup>239</sup> If the debtor and the debtor's spouse file a joint petition, the claims of creditors of both will be discharged to the extent consistent with section 523. If only the husband or only the wife files a petition for liquidation, the discharge received by that debtor will obviously not affect the creditor whose claim is assertable against separate property of the non-filing spouse. However, where only one spouse files, the discharge will, by virtue of section 524(a)(3), preclude any creditor holding a dischargeable claim which was assertable against community property of the debtor (even such a creditor who extended credit to the non-filing spouse) from seeking to enforce that claim by resorting to any community property that is acquired by the debtor or the debtor's spouse after the commencement of the case.<sup>240</sup> Since community property was oth-

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235. 11 U.S.C.A. § 524(a)(2) (West Spec. Pamp. 1979).

236. The automatic stay, effective upon the filing of the petition, is described in section 362. *Id.* § 362. With respect to liquidation, the automatic stay of section 362 codifies and expands the automatic stay provided under Rule 401 and Rule 601 of the Bankruptcy Rules, effective under the Bankruptcy Act of 1898. Bankruptcy Rules 401, 601, 11 U.S.C. app. at 1324, 1335 (1976).

237. CAL. CIV. CODE §§ 5116, 5120-5123 (West 1970 & Supp. 1979).

238. *See, e.g., id.* § 5121.

239. *See, e.g., id.* §§ 5116, 5122.

240. 11 U.S.C.A. § 524(a)(3) (West Spec. Pamp. 1979) reads:

A discharge in a case under this title—(3) operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, to collect or recover from, or offset against, property of the debtor of the kind specified in section 541(a)(2) of this title that is

erwise liable for payment of the debt, it is the community property, in effect, as well as the individual debtor (and the debtor's separate property) that is discharged from the obligation. Were the law otherwise, a discharge for a married debtor not accompanied by the discharge for the debtor's spouse would mean little other than protection of the debtor's separate property.

Section 525 prohibits certain forms of discrimination by a governmental unit against a debtor who has not paid a dischargeable debt.<sup>241</sup> The language of this section codifies and builds upon the holding of *Perez v. Campbell*.<sup>242</sup> In *Perez* the United States Supreme Court invoked the supremacy clause of the United States Constitution to forbid a state from denying reinstatement of a driver's license to a debtor whose bankruptcy had discharged a debt attributable to the debtor's fault in an automobile accident. Section 525 also appears to codify the result of *Handsome v. Rutgers*<sup>243</sup> which forbade a state university from denying transcripts to a debtor whose bankruptcy had discharged a student loan obligation. Section 525 does not expressly prohibit a private university from that same conduct and does not expressly prohibit other forms of private discrimination following discharge in bankruptcy, but the drafters apparently intended that the language of the section not limit courts in their determination of what types of discrimination are impermissible.<sup>244</sup>

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acquired after the commencement of the case, on account of any allowable community claim, except a community claim that is excepted from discharge under section 523 or 1328(c)(1) of this title, or that would be so excepted, . . . in a case concerning the debtor's spouse commenced on the date of the filing of the petition in the case concerning the debtor. . . .

Property specified in section 541(a)(2) is certain community property, *id.* § 541(a)(2), and a community claim is defined as a claim arising before the commencement of a case concerning a debtor for which the property specified in section 541(a)(2) is liable, *id.* § 101(6). See SENATE REPORT, *supra* note 114, at 80, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5866. The operation of section 524(a)(3) is qualified by section 524(b). 11 U.S.C.A. § 524(b) (West Spec. Pamp. 1979).

241. 11 U.S.C.A. § 525 (West Spec. Pamp. 1979).

242. 402 U.S. 637 (1971).

243. 445 F. Supp. 1362 (D.N.J. 1978).

244. SENATE REPORT *supra* note 114, at 81, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5867. Procedure for raising the issue of discrimination is to be explained in the Bankruptcy Rules. HOUSE REPORT, *supra* note 114, at 297, *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 6254.

*Debts Excepted from Discharge*

Like section 17 of the Bankruptcy Act, section 523 of title 11<sup>245</sup> excepts certain debts from discharge; the debtor's fresh start does not terminate all responsibility of the debtor for past conduct. The categories of debt for which the debtor remains responsible even after discharge are generally the same as in section 17 of the Bankruptcy Act: certain taxes;<sup>246</sup> debts incurred through use of a false financial statement or other types of fraud;<sup>247</sup> debts owed to certain creditors not scheduled by the debtor;<sup>248</sup> debts owed due to fraud while acting in a fiduciary capacity;<sup>249</sup> alimony and child support;<sup>250</sup> debts for wilful or malicious injury to the person or property of another;<sup>251</sup> fines payable to a governmental unit;<sup>252</sup> certain educational loans;<sup>253</sup> and debts which were scheduled or could have been scheduled in a prior bankruptcy in which the debtor waived or was denied a discharge.<sup>254</sup> Debts in four of these categories are frequently encountered in consumer insolvency counseling.

*The false financial statement and other fraud.* Section 523(a)(2) provides that a discharge under section 727 does not discharge an individual debtor from any debt:

for obtaining money, property, services, or an extension, renewal, or refinancing of credit, by —

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition; or

(B) use of a statement in writing —

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for obtaining such money, property, services, or credit reasonably relied; and

245. 11 U.S.C.A. § 523 (West Spec. Pamp. 1979).

246. *Id.* § 523(a)(1). Property of the debtor which is exempt under section 522 remains liable for such debts. *Id.* § 522(c)(1).

247. *Id.* § 523(a)(2).

248. *Id.* § 523(a)(3).

249. *Id.* § 523(a)(4).

250. *Id.* § 523(a)(5). Property of the debtor which is exempt under section 522 remains liable for such debts. *Id.* § 522(c)(1).

251. *Id.* § 523(a)(6).

252. *Id.* § 523(a)(7).

253. *Id.* § 523(a)(8).

254. *Id.* § 523(a)(9).

- (iv) that the debtor caused to be made or published with intent to deceive;<sup>255</sup>

This section, with some refinements, preserves the exception to discharge stated in section 17a.(2) of the Bankruptcy Act.<sup>256</sup>

Considerable debate in the legislative hearings preceding enactment of the Bankruptcy Reform Act centered on the exception to discharge for debts incurred through use of a false financial statement.<sup>257</sup> Persons representing debtor interests insisted that the allegation of the debtor's use of a false financial statement continued, even after the 1970 amendments to the Bankruptcy Act,<sup>258</sup> to be used unfairly by creditors (most frequently personal property brokers) to leverage reaffirmation of debts after bankruptcy.<sup>259</sup> Persons representing creditors insisted that the false financial statement exception to discharge was not abused by creditors and that the financial statement

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255. *Id.* § 523(a)(2).

256. Bankruptcy Act of 1898, ch. 541, § 17(a)(2), 30 Stat. 550 (as amended) (formerly 11 U.S.C. § 35(a)(2) (1976)).

257. Compare *House Hearings*, *supra* note 8, pt. 2, at 801-03 with *id.* at 899.

258. Section 17a.(2) of the Bankruptcy Act of 1898 was amended in 1970, Act of Oct. 19, 1970, Pub. L. No. 91-467, 84 Stat. 990. The primary purpose of the amendment was to "effectuate, more fully, the discharge in bankruptcy by rendering it less subject to abuse by harassing creditors." H.R. REP. No. 1502, 91st Cong., 2d Sess. 1, *reprinted in* [1970] U.S. CODE CONG. & AD. NEWS 4156. Prior to the amendment, creditors were permitted to sue in state court after a discharge in bankruptcy was granted, asserting nondischargeability on grounds enumerated in section 17a. Often the debtor would not appear in the state court action either because of misplaced reliance on the discharge, inability to retain an attorney because of lack of funds, or because he or she was not properly served with process. As a result, a default judgment would be entered against the nonappearing debtor, again subjecting his or her wages or property to garnishment or levy of execution. "All this results because the discharge is an affirmative defense which if not pleaded, is waived." *Id.*

Most commonly, the state court action was initiated by a creditor claiming that a debt owed was nondischargeable because of a false financial statement of the debtor. To curb this sharp practice, the 1970 amendments to section 17 required determinations of dischargeability concerning certain debts, including debts allegedly incurred in reliance upon a false financial statement, to occur exclusively in bankruptcy court within prescribed time limits. Absent timely application by an affected creditor, the debt was discharged and further creditor action was barred. Act of Oct. 19, 1970, Pub. L. No. 91-467, §§ 2, 3, 84 Stat. 990, 991. See Countryman, *The New Dischargeability Law*, 45 AM. BANKR. L.J. 1 (1971); Shuchman, *The Fraud Exception in Consumer Bankruptcy*, 23 STAN. L. REV. 735, 765-69 (1971). For a case history and reproduction of documents in connection with a creditor's application for determination of dischargeability under the 1970 amendments see *In Re Hill*, Bankr. No. 28,738 (E. Tenn. 1971), *reprinted in House Hearings*, *supra* note 8, pt. 2, at 981-1005. For statistics concerning applications for determination of dischargeability under the 1970 amendments see *id.* at 924, 942.

259. See, e.g., *In Re Hill*, Bankr. No. 28, 738 (E. Tenn. 1971), *reprinted in House Hearings*, *supra* note 8, pt. 2, at 873.



obtained from debtors prior to the extension of credit was a meaningful input to the decision of the creditor to extend or deny credit.<sup>260</sup> Congress responded to the debate by codifying in section 523(a)(2) the law stated in and developed under section 17a.(2) (materiality, reasonable reliance and intent to deceive)<sup>261</sup> and by seeking to discourage baseless assertions of exception to discharge under section 523(a)(2) through a grant of authority to the bankruptcy court to award costs and reasonable attorney's fees to a debtor in the event that a debtor prevails in a hearing to determine dischargeability under section 523(a)(2).<sup>262</sup>

The creditor seeking to except a debt from discharge on the basis of an alleged false financial statement will thus continue to bear a heavy burden of proof and may well be deterred from trying by the prospect of having to pay costs and attorney's fees. Increased sophistication in credit reporting will make it difficult for the creditor to base a claim of reasonable reliance upon a false financial statement if alternative sources of credit verification are easily accessible. Moreover, if the debtor can establish that the creditor encouraged the debtor to be somewhat carefree in the preparation of a financial statement, it would be impossible for the creditor to establish either the debtor's intent to deceive or the creditor's reasonable reliance.

As under section 17c of the Bankruptcy Act, the creditor seeking to except from discharge a debt allegedly incurred on the basis of a false financial statement must seek a determination of dischargeability in the bankruptcy court and may not litigate the matter in state court.<sup>263</sup> Title 11, unlike the Bankruptcy Act, leaves to the Bankruptcy Rules specification of the limited time period in which this request for determination must be made.<sup>264</sup>

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260. See *House Hearings*, *supra* note 8, at 899-900.

261. See, e.g., *Palter v. Lake Sales, Inc.*, 435 F.2d 120 (9th Cir. 1970) (where there were reasonable grounds for believing creditor relied on false financial statement, burden of proof shifted to bankrupt to show lack of reliance by creditor); *Rogers v. Gardner*, 226 F.2d 864 (9th Cir. 1955) (elements for precluding discharge of debt incurred on basis of false financial statement).

262. 11 U.S.C.A. § 523(a)(2) (West Spec. Pamp. 1979); HOUSE REPORT, *supra* note 114, at 129-31, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6090-92. Procedure for the awarding of costs and attorney's fees is left to the Bankruptcy Rules. *Id.* at 297, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6254.

263. 11 U.S.C.A. § 523(c) (West Spec. Pamp. 1979).

264. Section 17(c)(2) of the Bankruptcy Act provided that "a creditor who contends that his debt is not discharged under [§ 17a.(2)] must file an application for a

Section 17a.(2) of the Bankruptcy Act also excepted from discharge any debt obtained by other false pretenses or false representations, and section 523(a)(2) expands the former law to also except from discharge any debt obtained by other kinds of fraud. Section 523(a)(2) also adds that a debt for obtaining services, as well as a debt for obtaining money or property, shall be excepted from discharge if obtained by false pretenses, false representations, fraud, or false financial statement.

Finally, section 523(a)(2) explicitly states that a debt arising from renewal or refinancing of a previously existing debt shall not be excepted from discharge if obtained through fraud of the kinds listed. The language concerning refinancing and renewal was intended to codify certain case law<sup>265</sup> under which refinanced debt will be excepted from discharge only to the extent of fresh money advanced if the debt were refinanced pursuant to state law requiring that a creditor refinance existing credit even if there has been no default, but the entire debt will be excepted from discharge if the creditor is refinancing the debt in lieu of pursuing otherwise available remedies for the debtor's default.<sup>266</sup> The statutory language itself does not com-

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determination of dischargeability within the time fixed by the court pursuant to [§ 14b(1)] . . . and, unless an application is timely filed, the debt shall be discharged." Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 550 (as amended to § 17c(2)) (formerly 11 U.S.C. § 35(c)(2) (1976)). Section 14b(1) provided that the court issue an order fixing a time for filing objections to the bankrupt's discharge and for filing a § 17c(2) application "which time or times shall be not less than thirty days nor more than ninety days after the first date set for the first meeting of creditors." *Id.* § 14 (as amended to § 14b(1)) (formerly 11 U.S.C. § 32(b)(1) (1976)). The new Bankruptcy Rules will detail timing and procedure for a hearing to determine dischargeability of a debt. HOUSE REPORT, *supra* note 114, at 297, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6254.

265. In many cases, a creditor is required by state law to refinance existing credit on which there has been no default. If the creditor does not forfeit remedies or otherwise rely to his detriment on a false financial statement with respect to existing credit, than an extension, renewal or refinancing of such credit is non-dischargeable only to the extent of the new money advanced; on the other hand, if an existing loan is in default or the creditor otherwise reasonably relies to his detriment on a false financial statement with regard to an existing loan, then the entire debt is non-dischargeable under section 523(a)(2)(B). This codifies the reasoning expressed by the second circuit in *In Re Danns*, 558 F.2d 114 (2d Cir. 1977).

124 CONG. REC. S17,412 (daily ed. Oct. 6, 1978) (statement of Senator De Concini, D. Ariz.); 124 CONG. REC. H11,096 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards, D. Cal.).

266. *In Re Danns*, 558 F.2d 114, 116 (2d Cir. 1977). See *In re Peterson*, 437 F. Supp. 1068, 1070 (D. Minn. 1977); *In re Ellis*, 400 F. Supp. 1112, 1116 (S.D.N.Y. 1975); *In re McNee*, 390 F. Supp. 271, 272-73 (S.D.N.Y. 1975); *In re Fuhrman*, 385 F. Supp.

mand that result, however, and the question will no doubt be the subject of litigation.

*Alimony and child support.* Alimony and child support remain excepted from discharge unless the debt has been assigned.<sup>267</sup> It is sometimes difficult, of course, to decide whether a debtor's obligations arising from a dissolution of marriage are properly classifiable as alimony or child support or as property settlement. For example, a debtor will often be obligated by the terms of a property settlement agreement in a dissolution to pay certain debts incurred during marriage. This obligation to a former spouse may be in the nature of property settlement or, alternatively, it may be in the nature of indirect alimony, reducing the amount of alimony that the debtor might otherwise have been required to pay under the terms of the settlement agreement. Title 11 continues to leave interpretation of settlement agreements to case by case determination.<sup>268</sup>

If the question is not free from doubt in a particular case, there might be advantage to the debtor in seeking a determination on the issue in the bankruptcy court.<sup>269</sup> Otherwise, the

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1185 (W.D.N.Y. 1973); *In re Schuerman*, 367 F. Supp. 1347, 1350 (E.D. Ky. 1973); Townsend, "Fresh Cash" - Another Element of a Bankrupt's "Fresh Start"?, 31 U. MIAMI L. REV. 275, 281-86 (1977) (discussing "fresh cash" limitation in cases under section 17a.(2)). As noted in *Danns*: "Since Congress gave the federal courts exclusive jurisdiction over dischargeability questions in 1970 . . . a large majority of federal district courts and bankruptcy referees have concluded that only that portion of the credit obtained as a result of a fraudulent statement should be barred from discharge." 558 F.2d at 115-16.

267. 11 U.S.C.A. § 523(a)(5) (West Spec. Pamp. 1979); Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 550 (as amended to § 17a(7)) (formerly 11 U.S.C. § 35(a)(7) (1976)). Section 127(b) of the Technical Amendments Act, S. 658, 96th Cong., 1st Sess. (1979), reprinted in 125 CONG. REC. S2736-37 (daily ed. Mar. 14, 1979), proposes to amend the language of section 523(a)(5) such that debts for child support shall be excepted from discharge where assigned to a state in connection with aid to families with dependent children.

268. See generally *In re Birdseye*, 548 F.2d 321, 322-25 (10th Cir. 1977) (award of attorney's fees in divorce proceedings was in nature of alimony and support, rather than property settlement, and hence was a nondischargeable debt in subsequent bankruptcy proceeding initiated by debtor husband); *In re Cox*, 543 F.2d 1277 (10th Cir. 1977) (under state law, alimony judgment in lump sum payable in monthly installments pertains to division of property and was discharged in bankruptcy); *Jones v. Tyson*, 518 F.2d 678 (9th Cir. 1975) (property settlements are not in nature of alimony under California law and are dischargeable in bankruptcy).

269. Section 17c(1) of the Bankruptcy Act of 1898 authorized the bankrupt to file an application with the bankruptcy court to determine the dischargeability of any debt. Bankruptcy Act of 1898, ch. 541, § 17, 30 Stat. 550 (as amended to § 17c(1)) (formerly 11 U.S.C. § 35(c)(1) (1976)). That explicit authority was not carried forward to section 523 of title 11 because the same power is implicit in the broader grant of jurisdiction to the bankruptcy court in 28 U.S.C.A. § 1471(n) (West Supp. 1979)

debtor may find himself or herself the defendant in a cross-complaint filed by his or her former spouse in an action initiated by the unpaid creditor,<sup>270</sup> or the debtor may be named respondent in an order issued by the superior court with continuing jurisdiction over the dissolution to show cause why he or she should not be held in contempt for failing to comply with the terms of a marital property settlement agreement or decree of dissolution.<sup>271</sup> Of course, this problem could be avoided if the debtor succeeds in convincing his or her former spouse to also file a petition, in which case the obligations of both persons would be discharged (if the debts are otherwise dischargeable under section 523) and further creditor action would be barred.

*Wilful or malicious injury to property or person.* Section 523(a)(6) restates in one section the exception to discharge found in sections 17a.(2) (wilful and malicious conversion of the property of another) and 17a.(8) (wilful and malicious injuries to the person or property of another, other than conversion) of the Bankruptcy Act. Jurisdiction to determine dischargeability of a debt conceivably falling within the ambit of section 523(a)(6) rests exclusively with the bankruptcy court and a request for hearing by the interested creditor will need to be made within time limits to be fashioned by the Bankruptcy Rules.<sup>272</sup>

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(added by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 201(a), 92 Stat. 2668). SENATE REPORT, *supra* note 114, at 77, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5862-63.

270. In this scenario, the debtor receives a discharge in bankruptcy and refuses further payment to creditors who were to be paid by the debtor under the terms of the property settlement agreement or decree of dissolution. The creditor then sues the non-debtor former spouse whose share of the community property, and in some instances separate property, would be liable for the debt. The non-debtor former spouse then cross-complains against the debtor. At this point the debtor could interpose the defense of discharge to the cross-complaint and litigate that issue in state court or seek determination of the dischargeability of the debt in the bankruptcy court. *See* note 269 *supra*. If the bankruptcy case has been closed, the case may be reopened for this purpose under section 350 of title 11. 11 U.S.C.A. § 350 (West Spec. Pamp. 1979).

271. In this scenario, the debtor receives a discharge in bankruptcy and refuses further payment to creditors who were to be paid by the debtor under the terms of the property settlement agreement or decree of dissolution. The creditor then sues or threatens to sue the non-debtor former spouse. That spouse then seeks relief from the superior court having jurisdiction over the dissolution proceedings. CAL. CIV. CODE § 4380 (West Supp. 1979) (enforcement of court orders, judgments and decrees pursuant to Family Law Act); *see* Severdia v. Alamo, 41 Cal. App. 3d 881, 116 Cal. Rptr. 405 (1974); Sheldon v. Superior Ct., 257 Cal. App. 2d 541, 65 Cal. Rptr. 59 (1967). In response to the order to show cause the debtor would have the same options as those available for response to a cross-complaint. *See* note 270 *supra*.

272. 11 U.S.C.A. § 523(c) (West Spec. Pamp. 1979). *See also* note 264 and accompanying text *supra*.

There are two fairly common instances in which the issue of dischargeability under section 523(a)(6) issue will be presented. Often, a debtor seeking counseling will have incurred liability for injury to person or property resulting from an accident in which the debtor was driving while intoxicated. Courts must decide whether the debtor's action was wilful and malicious. Courts applying the language of section 17a.(2) have reached differing results, no doubt influenced by the particular facts in each case.<sup>273</sup> The language of section 523(a)(6) of title 11 provides no further guidance for resolution of the issue. Language in the House Report<sup>274</sup> indicates that choice of the word "wilful" (the same language employed by section 17a.(8) of the Bankruptcy Act) is intended to overrule *Tinker v. Colwell*<sup>275</sup> which had held that mere "reckless disregard" was conduct sufficiently culpable to except a resulting debt from discharge. To the extent that this guidance in the legislative history is followed, and wilful is found to mean wilful, there may be fewer cases than at present in which debts arising from injuries inflicted by virtue of drunk driving will be nondischargeable.

The insolvency counselor may also discover that the client has disposed of personal household belongings which constituted collateral for a secured loan, such as a loan from a personal property broker. In many instances the lien of the security interest will be avoided and the creditor will have no basis for a claim of conversion.<sup>276</sup> Even if the lien is not avoided, it will frequently be difficult for the creditor to prove that disposition of the collateral was wilful and malicious; in many if not most cases the debtor disposes of personal household belongings simply because they no longer have any value. Moreover, there is little sense, because there is no damage, to a creditor asserting a claim for conversion of a refrigerator that will no longer freeze or a couch that is in shreds. Further, any debt for wilful and malicious conversion will be discharged unless the creditor seeks a determination of dischargeability in the bank-

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273. Compare *In re Smith*, 161 F. Supp. 896, 897 (W.D.N.Y. 1956) (default judgment based on operation of motor vehicle while debtor intoxicated based on "wilful and malicious misconduct" and nondischargeable in bankruptcy) with *Dillard v. Dillard*, 244 Or. 597, 418 P.2d 839, cert. denied, 386 U.S. 983 (1966) (mere fact that one injures another while driving intoxicated does not necessarily establish debtor's conduct was "wilful and malicious" within meaning of § 17a(8)).

274. HOUSE REPORT, *supra* note 114, at 365, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6320.

275. 193 U.S. 473 (1902).

276. See note 181 and accompanying text *supra*.

ruptcy court within specified time limits.<sup>277</sup> Timely action by creditors is unlikely because they often fail to inquire about the location or condition of the collateral until after the time limit has expired.

*Educational loans.* The recent history of dischargeability of educational loans is bizarre, largely because of the continuing controversy about the fairness of singling out educational loans for exception from discharge.<sup>278</sup> Prior to October 1, 1977, educational loans were dischargeable.<sup>279</sup> Between October 1, 1977 and November 6, 1978, federally insured educational loans<sup>280</sup> were excepted from discharge unless the loan first became due more than five years prior to the receipt of discharge in a pending bankruptcy or unless the debtor could demonstrate that repayment would constitute undue hardship to the debtor or the debtor's family.<sup>281</sup> During that same period, with

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277. 11 U.S.C.A. § 523(c) (West Spec. Pamp. 1979). See also note 264 and accompanying text *supra*.

278. See *House Hearings*, *supra* note 8, at 1065-1140; HOUSE REPORT, *supra* note 114, at 132-64, 536-38, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6093-6125, 6423-25.

The rate of educational loans discharged in bankruptcy has risen dramatically in recent years. However, the rise appears not to be disproportionate to the rise in the amount of loans becoming due or to the default rate generally on educational loans. The rise has been slightly higher than the rise in the bankruptcy rate overall. The sentiment for an exception to discharge for educational [loans] does not derive solely from the increase in the number of bankruptcies. Instead, a few serious abuses of the bankruptcy laws by debtors with large amounts of educational loans, few other debts, and well-paying jobs, who have filed bankruptcy shortly after leaving school and before any loans became due, have generated the movement for an exception to discharge.

*Id.* at 133, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6094.

279. September 30, 1977 was the postponed effective date of a provision to except federally insured educational loans from discharge. Higher Education Act of 1965, § 439A, 20 U.S.C. § 1087-3 (1976) (added by Education Amendments Act of 1976, Pub. L. No. 94-482, § 127(a), 90 Stat. 2141) (originally effective Oct. 1, 1976).

280. The federally insured student loan program was created in the Higher Education Act of 1976, 20 U.S.C. §§ 1070-1089 (1976). In contrast to other educational loans, under this program the government guarantees an educational loan made by a private institutional lender and, in the event of default by the debtor, the government is subrogated to or is assigned the rights of the private lender. *Id.* § 1078-1 (insurance program); *id.* § 1080 (default and subrogation provisions).

281. *Id.* § 1087-3 (1976). See *Wisconsin Higher Educ. Bd. v. MacPherson*, 4 Bankr. Ct. Dec. 950 (W.D. Wis. 1978) (court may consider whether partial amount of loan dischargeable or whether payment by deferred installments within debtor's means in determining "undue hardship"); *Hayman v. Wilmington Trust Co. & United Student Aid Fund, Inc.*, 4 Bankr. Ct. Dec. 932 (S.D. Fla. 1978) (court's discretion not intended to be exercised to permit discharge where debtor's hardship self-imposed by living beyond his means); *New York State Higher Educ. Services Corp. v. Moore*, 4

some exceptions, all other educational loans remained dischargeable.<sup>282</sup>

From November 6, 1978 (the enactment date of the Bankruptcy Reform Act) until October 1, 1979 (the effective date of title 11), all educational loans again were dischargeable,<sup>283</sup> possibly because of legislative oversight.<sup>284</sup> Effective October 1, 1979, however, all educational loans repayable to a governmental unit or nonprofit institution of higher education are excepted from discharge unless the loan first became due more than five years prior to the filing of the petition or unless repayment of the loan would constitute an undue hardship for the debtor and debtor's dependents.<sup>285</sup>

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Bankr. Ct. Dec. 432 (W.D.N.Y. 1978) (court considers present and future income and expenses in determining "undue hardship"); *Pennsylvania Higher Educ. Assistance Agency v. Glover*, 4 Bankr. Ct. Dec. 786 (E.D. Pa. 1978) (seeing no prospect of bankrupt's ability to pay loan out of future income, loan is discharged); *Ohio v. Kirsch*, 4 Bankr. Ct. Dec. 680 (S.D. Ohio 1978) (strict construction of "undue hardship").

282. Compare *State v. Wilkes*, 41 N.Y.2d 655, 363 N.E.2d 555, 394 N.Y.S.2d 849 (1977) (National Direct Student Loan not dischargeable because too contingent to be "provable" claim under Bankruptcy Act § 63) with *Oregon v. Mwongozi*, 4 Bankr. Ct. Dec. 120 (D. Or. 1978) (National Direct Student Loan provable and hence dischargeable).

283. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 317, 92 Stat. 2678 provides: "Section 439A of part B of title IV of the Higher Education Act of 1965 (20 U.S.C. 1087-3) is repealed." *Id.* § 402(d) provides that § 317 is effective "on the date of enactment of this Act." The effective date of repeal, then, was November 6, 1978. Under the terms of the Bankruptcy Reform Act, *id.* § 402(a), 92 Stat. 2682, § 533(a)(8) (excepting educational loans from discharge) took effect October 1, 1979. Thus, in cases filed between the repeal of 20 U.S.C. § 1087-3 and the effective date of § 523(a)(8), from November 6, 1978 to October 1, 1979, student loans were dischargeable. *Contra Wisconsin Higher Educ. Aids Bd. v. Edson*, 4 Bankr. Ct. Dec. 1191 (D. Nev. Jan. 22, 1979) (dictum). See author's Addendum *infra*.

284. The Technical Amendments Act, S. 658, 96th Cong., 1st Sess. (1979) reprinted in 125 CONG. REC. S2736 (daily ed. Mar. 14, 1979), and H.R. 2807, 96th Cong., 1st Sess. (1979) each proposed, in slightly different fashion, to shorten the apparently inadvertent gap between November 6, 1978 and October 1, 1979 during which educational loans were again dischargeable (see note 283 *supra*) by reinstating the exception to discharge for educational loans. See author's Addendum *infra*.

285. The first condition of dischargeability (expiration of five years) is slightly different from the comparable condition stated in former 20 U.S.C. § 1087-3. Unlike section 1087-3, the five year period under section 523(a)(8) runs from the time the obligation first became due until the time of the filing of the petition, not to the time of receipt of discharge. This change precludes a debtor from filing a petition prior to the expiration of the five year period but hoping to delay the discharge until after the five year period. 11 U.S.C.A. § 523(a)(8) (West Spec. Pamp. 1979). Determination of undue hardship under section 523(a)(8) will no doubt be influenced by cases confronting the same issue under previous law. See note 281 *supra*.

*The discharge hearing*

In most cases under the Bankruptcy Act, the debtor needed to travel to court only once, there to attend the first meeting of creditors.<sup>286</sup> Section 524(d) of title 11 may require a second trip, to attend the discharge hearing. At this hearing the bankruptcy court will inform the debtor that a discharge has been granted or why a discharge has been denied. In addition, the court will evaluate and then either approve or disapprove any agreement of the debtor to reaffirm a pre-petition debt as well as explain to the debtor his or her rights concerning reaffirmation.

There appear to be two basic purposes for this hearing: To help enforce the new law's restrictions upon reaffirmation<sup>287</sup> and to impress upon the debtor the meaning of the discharge and the solemnity of the bankruptcy proceedings. This latter purpose is no longer served, if it ever was, by the first meeting of creditors because title 11 prohibits the solemnizer, the bankruptcy judge, from attending that meeting.<sup>288</sup> In cases in which the debtor has decided or has been induced to reaffirm an otherwise dischargeable debt and in cases where the debtor seeks court approval for the redemption of property from a lien,<sup>289</sup> the discharge hearing seems a useful procedure. In other cases, however, particularly where the debtor is advised by competent counsel, the discharge hearing seems unnecessary. There is little solemnity or information that the judge can provide that could not be provided by counsel, especially if the bankruptcy judge advises debtors in the same fashion as many judges in criminal arraignments advise amassed defendants of their constitutional rights.

In addition, the requirement to attend this hearing will prove very inconvenient to the many debtors who wish to relocate their residence as soon as possible after filing the petition, unless the hearing is scheduled immediately following the first meeting of creditors. Often an insolvent debtor wishes the

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286. Bankruptcy Act of 1898, ch. 541, § 7a(1), 30 Stat. 548 (as amended) (formerly 11 U.S.C. § 25(a)(1) (1976)). Additional trips were necessary in some cases, such as a case in which a creditor sought a hearing on the dischargeability of a debt.

287. See text accompanying notes 291-303 *infra*.

288. 11 U.S.C.A. § 341(c) (West Spec. Pamp. 1979). The Bankruptcy Rules will specify the procedure for examination of the debtor at the first meeting of creditors. HOUSE REPORT, *supra* note 114, at 294, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6251.

289. See text accompanying notes 295-98 *infra*.



freshness of new environs as well as the fresh start offered by bankruptcy. Finally, the requirement to attend this hearing may boost attorney's fees charged for representation in the case.<sup>290</sup>

In considering the grounds for denial of discharge and the kinds of debts which will be excepted from discharge, one finds only a partial answer to the client's inquiry about the impact of bankruptcy upon the client's debts. The remainder of the answer comes with a consideration of reaffirmation of debt and redemption of collateral subject to a lien.

### *Reaffirmations and Redemptions*

The congressional hearings preceding the enactment of the Bankruptcy Reform Act document the standard post-petition practice of creditors, particularly secured creditors, pressuring debtors to reaffirm debts which will be or have been discharged in the bankruptcy.<sup>291</sup> The secured creditor's leverage for reaffirmation derives from the threat to repossess collateral, usually household furnishings or an automobile, which is almost always more valuable to the debtor than to the creditor because the replacement cost but not the resale value of such collateral is high. Consumer debtors also reaffirm debts to unsecured creditors where compelled by some special bond of obligation, filial or otherwise. Thus, consumer debtors will frequently reaffirm debts owed relatives, or physicians, or credit unions affiliated with their employer, or creditors whose debts are guaranteed by a friend or relative of the bankrupt who has not filed and does not contemplate filing bankruptcy. Of course, the greater amount of debt reaffirmed, the less valuable the bankruptcy, particularly because the right to a discharge in bankruptcy arises only once every six years.<sup>292</sup>

Congress has restricted the potential for post-petition reaffirmation in several ways. As discussed previously, the debtor has been granted the power to avoid non-purchase money non-possessory security interests in certain otherwise exempt property.<sup>293</sup> Personal property brokers are the most frequent holders

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290. Attorney's fees for straight bankruptcy generally range between \$200 and \$350 in Santa Clara County. These fees are generally quoted as covering the client interview, preparation and filing of the petition and accompanying schedules, and attendance with the client at the first meeting of creditors.

291. *House Hearings, supra* note 8, at 761-62, 874-75, 943, 946.

292. *See* note 230 and accompanying text *supra*.

293. *See* text accompanying notes 181-87 *supra*.

of such security interests and are among the most assertive in using the existence of the security interest to leverage reaffirmation.<sup>294</sup> Where such security interests are avoided, the leverage is eliminated.

Section 722 of title 11 also undercuts the leverage of other secured creditors seeking reaffirmation. Under section 722, any holder of an allowed secured claim must permit the debtor to redeem tangible *personal* property intended primarily for personal, family or household purposes from the lien of the security interest where the lien secured a dischargeable consumer debt and where the property involved is exempt under section 522 or has been abandoned under section 554.<sup>295</sup> This section will of course be superfluous in those cases in which the lien is avoided, such as under section 522(f), but will be of enormous value to consumer debtors who wish to retain personal property subject to a lien which cannot be avoided. This right of redemption will no doubt most frequently be used to redeem automobiles from purchase money security interests. Automobile secured lenders have heretofore frequently insisted upon reaffirmation of the entire amount of a secured debt as the only alternative to repossession, even if the debt were undersecured at the time the petition was filed.<sup>296</sup>

Under section 722, the creditor must allow the debtor to redeem the collateral by paying the creditor the amount of the creditor's allowed secured claim.<sup>297</sup> If the debtor can afford this redemption, the debtor may retain the collateral without committing to repay what often may be the substantially larger sum of the outstanding debt which will be or has been dis-

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294. See note 182 and accompanying text *supra*.

295. 11 U.S.C.A. § 722 (West Spec. Pamp. 1979).

296. For example, a bank which held the pink slip to an automobile worth \$1,000 to secure a debt of \$2,000 often would insist upon reaffirmation of the entire debt rather than accept \$1,000 in settlement of the bank's interest in the automobile. This practice of automobile secured lenders contrasts sharply with the practice of personal property brokers who have almost always been willing to accept payment of the fair market value of household goods in settlement of their security interest in those items. See note 184 *supra*.

297. The amount of the allowed secured claim is equivalent to the value of the secured party's interest in the estate's interest in the property, 11 U.S.C.A. § 506(a) (West Spec. Pamp. 1979), which will be the value of the collateral or the amount of the creditor's claim, whichever is less. That value is to be determined "in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use. . . ." *Id.* The hearing will be the discharge hearing. *Id.* § 524(c)(4)(B)(ii). The Bankruptcy Rules will provide for the method of valuation. HOUSE REPORT, *supra* note 114, at 299, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6256.

charged. The statute does not state whether this right of redemption includes the right of the debtor to demand, or the right of the creditor to allow, a redemption by installment payments.<sup>298</sup>

Section 524(c) of title 11 is the remaining hurdle to post-petition reaffirmation. That section provides as follows:

(c) An agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under this title is enforceable only to any extent enforceable under applicable nonbankruptcy law, whether or not discharge of such debt is waived, only if —

(1) such agreement was made before the granting of the discharge under section 727, 1141, or 1328 of this title;

(2) the debtor has not rescinded such agreement within 30 days after such agreement becomes enforceable;

(3) the provisions of subsection (d) of this section have been complied with; and

(4) in a case concerning an individual, to the extent that such debt is a consumer debt that is not secured by real property of the debtor, the court approves such agreement as —

(A) (i) not imposing an undue hardship on the debtor or a dependent of the debtor; and

(ii) in the best interest of the debtor; or

(B) (i) entered into in good faith; and

(ii) in settlement of litigation under section 523 of this title, or providing for redemption under section 722 of this title.<sup>299</sup>

Subsection 524(d), to which section 524(c)(3) refers, requires the bankruptcy court to hold a hearing at which the debtor shall be informed concerning his or her discharge and also informed about his or her rights concerning and the effect of a reaffirmation of a dischargeable debt.<sup>300</sup>

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298. Surely the creditor ought to be able to permit payment in installments; it is not nearly so clear that the debtor ought to be able to insist upon repayment in installments. The Bankruptcy Rules may treat this issue. HOUSE REPORT, *supra* note 114, at 299, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6256. The National Consumer Law Center, Inc., urged a provision allowing a debtor to insist upon installment redemption. *House Hearings*, *supra* note 8, at 941 (testimony of Ernest L. Sarason, Jr., Staff Attorney).

299. 11 U.S.C.A. § 524(c) (West Spec. Pamp. 1979).

300. See text accompanying notes 286-87 *supra*.

These restrictions upon reaffirmation are fairly severe, reflecting the congressional conclusion that the practice is much abused and substantially undercuts the fresh start intended by bankruptcy law. Indeed, one is somewhat hard pressed to imagine many debts, other than those which are to be approved under the separate standards of section 524(c)(4)(B),<sup>301</sup> the reaffirmation of which will be in the best interest of the debtor. A debt to a family physician may be one such debt because the best interest of the debtor and his or her family may be served by retaining the good will and hence the services of the physician. A debt owed to a credit union affiliated with the debtor's employer, with whom the debtor wishes to maintain cordial working relations, may be another debt the reaffirmation of which may serve the best interest of the debtor. There will probably be others in the specific circumstances of an individual case, but the bankruptcy courts are unlikely to lightly approve reaffirmation agreements in view of the evident congressional intent to curb the practice.

Any reaffirmation agreement is enforceable, in any event, only to the "extent enforceable under applicable nonbankruptcy law."<sup>302</sup> Thus, section 524(c) incorporates the provision of California's Fair Debt Collection Practices Law concerning reaffirmation of debts discharged in bankruptcy. Under section 1788.14(a) of the California Civil Code,<sup>303</sup> a creditor may not seek a reaffirmation of a discharged debt without clearly and conspicuously disclosing to the debtor in writing at the time the reaffirmation is sought that the debtor is not legally obligated to reaffirm. Creditors who seek reaffirmation in California will therefore need to include this written disclosure in their post-petition collection practices and debtors will be thus given additional protection against the pressure to reaffirm.

It should be noted, in closing, that nothing in title 11 precludes a debtor from making such voluntary payments on debts which have been discharged in bankruptcy as the debtor is able and wishes to make.

To facilitate a client's choice of action for relief from the distress of insolvency, it is crucial for the attorney to understand and be able to cogently explain rights afforded debtors by title 11. For the alternative of liquidation and discharge,

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301. 11 U.S.C.A. § 524(c)(4)(B) (West Spec. Pamp. 1979).

302. *Id.* § 524(c).

303. CAL. CIV. CODE § 1788.14(a) (West Supp. 1979).

title 11 provides significant new measures of debtor protection, including more generous and more flexible exemptions for a post-petition fresh start and greater constraints on post-petition reaffirmation of debt. Liquidation and discharge are, of course, but one form of debtor relief afforded by bankruptcy law. Bankruptcy law also affords the important alternative of court supervised adjustment of debts by way of extension or composition.

#### ADJUSTMENT OF DEBTS OF A PERSON WITH REGULAR INCOME

In 1938, Congress amended the Bankruptcy Act to include Chapter XIII, entitled Wage Earners' Plans.<sup>304</sup> The provisions of Chapter XIII permitted certain debtors to propose and implement a plan, under the supervision and protection of the bankruptcy court, under which the debtor could pay from future earnings all or a portion of his or her debts over a period of time not to exceed three years.<sup>305</sup> The purpose of Chapter XIII was to allow debtors who wished to pay all or a portion of their debts or who wished to avoid the stigma of bankruptcy to do so, free of wage garnishments or other collection efforts by which some creditors might frustrate the debtor's efforts to pay all creditors in installments and which might drive the debtor to an undesired bankruptcy.<sup>306</sup> Of course Chapter XIII

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304. Chandler Act of 1938, ch. 575, 52 Stat. 930 (adding §§ 601-686 to the Bankruptcy Act of 1898, formerly 11 U.S.C. §§ 1001-1086 (1976)). For a discussion of Chapter XIII proceedings under the Bankruptcy Act, see D. GILL, *PERSONAL BANKRUPTCY AND WAGE EARNER PLANS* (C.E.B. 1971); Bare, *New Rules in Straight and Chapter XIII Bankruptcies*, 41 TENN. L. REV. 567 (1974); Note, *Chapter XIII Wage Earner Petitions Under the New Federal Rules of Bankruptcy*, 4 MEM. ST. U. L. REV. 554 (1974).

305. Chapter XIII of the Bankruptcy Act did not specifically limit the payment plan to three years but many courts declined to confirm plans with a longer payment period, perhaps relying on the language of section 661 of the Bankruptcy Act. Bankruptcy Act of 1898, ch. 541, § 661, *added by* Chandler Act of 1938, ch. 575, § 1, 52 Stat. 936 (formerly 11 U.S.C. § 1061 (1976)). Section 1322(c) of title 11 permits courts to confirm plans providing for payments over a period of not to exceed five years. 11 U.S.C.A. § 1322(c) (West Spec. Pamp. 1979).

306. U.S. ATT'Y GEN., *REPORT TO THE PRESIDENT ON THE BANKRUPTCY ACT AND ITS ADMINISTRATION IN THE COURTS OF THE UNITED STATES*, S. DOC. NO. 65, 72nd Cong., 1st Sess. 80 (1932).

Our inquiry has led us to the following conclusions:

- (1) That most wage earners who fall into debt desire to pay their debts in full and wish to avoid the stigma of bankruptcy;
- (2) that they are driven into bankruptcy chiefly by garnishment and other attachments, even in the midst of an effort to pay in installments;
- (3) that at least a third of the wage earners who are forced into bankruptcy and released from their debts could, if given time and protection, pay their creditors in full;
- (4) that if the law offered such relief without stigma, a larger

relief was only available to the debtor whose anticipated future earnings were sufficient to make payments called for by the proposed plan in addition to payment of daily living expenses during administration of the plan. Moreover, Chapter XIII relief was unnecessary where the debtor could negotiate and implement a payment plan with the voluntary consent of creditors.<sup>307</sup>

Given the differences between Chapter XIII and the provisions of the Bankruptcy Act governing liquidation and discharge, there were additional reasons why a debtor might have chosen the relief afforded by Chapter XIII. First, a debtor could preserve existing or anticipated assets that would not be exempt in a liquidation and that the debtor was unwilling or unable to convert to exempt property. In a wage earners' proceeding, the debtor was entitled to keep his or her property because future earnings, not proceeds from the liquidation of the debtor's property, were to be used to pay creditors.<sup>308</sup> Sec-

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number of wage earners, who now resort to loan companies in an effort to stave off creditors and gradually get into debt beyond their capacity to pay, would find a means of relief at a comparatively early stage of indebtedness . . . .

*Id.*

307. In many areas of the country, consumer credit counseling services will assist a debtor in arranging a payment plan by contacting the debtor's creditors and obtaining their consent to a payment plan. Typically, the counseling service will charge a small fee to cover expenses, usually less than fees which would be paid to a trustee under Chapter 13. See 11 U.S.C.A. § 1302(e) (West Spec. Pamp. 1979) (fees collected by trustee). A consumer debtor utilizing such a service would also be able to avoid incurring attorney's fees for a Chapter 13. The Consumer Credit Counselors of Santa Clara County will decline to assist any individual whose income is insufficient to implement a payment plan.

308. Bankruptcy Act of 1898, ch. 541, § 646(4), added by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 934 (formerly 11 U.S.C. § 1046(4) (1976)) required that a plan under Chapter XIII "include provisions for the submission of future earnings or wages of the debtor to the supervision and control of the court for the purpose of enforcing the plan . . ." This requirement is carried forward in Chapter 13. 11 U.S.C.A. § 1322(a)(1) (West Spec. Pamp. 1979). In addition, the debtor may but need not provide for payment from property of the estate (property of the debtor as of the filing of the petition, *id.* § 541(a)) or other property of the debtor (property, including but not limited to earnings, acquired by the debtor after the filing of a petition, other than property described in section 541(a)(5)). *Id.* § 1322(b)(8). Except as provided in a confirmed plan or in an order confirming a plan, the debtor remains in possession of property of the estate and is vested with all property of the estate free and clear of the claim or interest of any creditor provided for in the plan. *Id.* §§ 1306(b), 1327(b),(c). The rule of section 1306(b) takes precedence over the rule of section 521(3) which requires the debtor to surrender possession of property of the estate to the trustee. *Id.* § 521(3).

Rule 13-403, superceding section 637 of the Bankruptcy Act of 1898, nevertheless required that the debtor claim exemptions in the Chapter XIII statement filed with

ond, a debtor could provide in the payment plan for the payment of creditors whose debts would not be dischargeable in a liquidation, such as arrearages in alimony and child support.<sup>309</sup> Third, a debtor was allowed the protection of the bankruptcy court during payment under an extension plan even though the debtor had been granted discharge in a liquidation proceeding commenced within the preceding six years. While section 14 of the Bankruptcy Act precluded discharge in a liquidation too closely following a preceding liquidation, it did not bar confirmation of an extension plan proposed closely following a liquidation proceeding.<sup>310</sup> Fourth, a debtor might re-establish a favorable credit rating. Some creditors were more willing to extend credit to a debtor who had completed payments under a wage earners' plan than to a debtor who had discharged debts in a liquidation.<sup>311</sup> Fifth, a debtor could provide in the plan for payment of certain claims which could arise subsequent to the filing of the petition for relief,<sup>312</sup> whereas in a liquidation only those dischargeable debts existing at the date of the filing of the petition are discharged. Sixth, a debtor could forestall re-

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the petition in anticipation of the possibility that the case could be converted to a liquidation. Bankruptcy Rule 13-403, 11 U.S.C. app. at 1549 (1976). Section 522(l) of title 11 requires that a debtor file a list of property claimed as exempt and this requirement applies to cases under Chapter 13 because the provisions of Chapter 5 apply to cases under Chapter 13. 11 U.S.C.A. §§ 103(a), 522(l) (West Spec. Pamp. 1979). In a case under Chapter 13, the listing of property claimed as exempt will serve the additional function of enabling the court and interested parties to determine whether payments to unsecured creditors under the plan are not less than amounts that would have been available for distribution to creditors had the debtor sought liquidation under Chapter 7. See text accompanying notes 335-36 *infra*.

309. *In re Willett*, 265 F. Supp. 999, 1001 (S.D. Cal. 1967).

310. *Perry v. Commerce Loan Co.*, 383 U.S. 392, 399 (1966). The ability to propose an extension closely following discharge in a preceding liquidation was especially important for those many debtors who experienced financial distress after their earlier discharge. Under title 11, apparently, a debtor may be granted a Chapter 13 discharge closely following a prior liquidation discharge whether the Chapter 13 plan is an extension or a composition. See note 340 and accompanying text *infra*. However, some composition plans proposed shortly following discharge in a liquidation may not be confirmed. See text preceding note 348 *infra*.

One should distinguish between the case in which Chapter 13 relief is sought subsequent to relief under Chapter 7 (or relief under the liquidation provisions of the Bankruptcy Act) from the case in which Chapter 7 relief is sought subsequent to relief under Chapter 13 (or relief under Chapter XIII of the Bankruptcy Act). Issues relating to the first case are discussed in the preceding paragraph of this note. Issues relating to the second case are discussed in notes 230-32 and accompanying text *supra*.

311. See also note 113 *supra*.

312. See Bankruptcy Rule 13-305, 11 U.S.C. app. at 1543 (1976). The effect of Rule 13-305 is carried forward in section 1305 of title 11. 11 U.S.C.A. § 1305 (West Spec. Pamp. 1979).

possession or foreclosure in secured transactions and thus gain time to cure defaults where the debtor did not otherwise wish to seek the relief of liquidation.<sup>313</sup>

Despite these significant advantages of Chapter XIII, the number of Chapter XIII cases filed in some parts of the country was dramatically different from the number of such cases filed in other parts of the country.<sup>314</sup> These differences could be explained partially by the differing attitudes of debtors, creditors, and judges in the community of the debtor's residence, partially by the differing attitudes and expertise of attorneys who render insolvency counseling services in the debtor's community, and partially by the limitations of Chapter XIII.<sup>315</sup>

Chapter 13 of title 11 preserves all of the advantages of Chapter XIII of the Bankruptcy Act described above<sup>316</sup> and introduces dramatic changes, some perhaps unintended. Some of these changes appear to provide startling new powers for the debtor, powers which would enable the debtor to achieve far more than was originally intended by Congress in its 1938 enactment of Chapter XIII.<sup>317</sup> In fact, under possible interpretations of Chapter 13, one might claim that there no longer is any good reason for a debtor to seek the relief of liquidation and discharge! If these possible interpretations are accepted by bankruptcy judges and are not precluded by congressional amendment to Chapter 13, the rise in the number of Chapter 13 filings throughout the country may be dramatic.<sup>318</sup>

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313. See Bankruptcy Rule 13-401, 11 U.S.C. app. at 1547 (1976). The effect of Rule 13-401 is carried forward in section 362 of title 11, 11 U.S.C.A. § 362 (West Spec. Pamp. 1979). See also text accompanying note 359 *infra*.

314. *The Bankruptcy Reform Act: Hearings on S. 235 and S. 236 Before the Subcomm. on Improvements in Judicial Machinery of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess., 8 (1975); McDuffee, *The Wage Earner's Plan in Practice*, 15 VAND. L. REV. 173 (1961).

315. HOUSE REPORT, *supra* note 114, at 117, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6077-78; SENATE REPORT, *supra* note 114, at 12-13, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5798-99.

316. See notes 308-13 *supra*.

317. But see HOUSE REPORT, *supra* note 114, at 118, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6078-79.

318. The House Report on H.R. 8200 implies that a rise in the number of Chapter 13 filings is desirable. "The premises of the bill with respect to consumer bankruptcy are that use of the bankruptcy law should be a last resort; that if it [relief under title 11] is used, debtors should attempt repayment under Chapter 13 . . ." *Id.* Despite the intent to encourage use of Chapter 13, Congress declined the invitation of some to condition the availability of relief under Chapter 7 upon a finding that a debtor would be unable to fund a plan under Chapter 13. Telephone conversation with Kenneth Klee, Esq., formerly Associate Counsel to the House Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary (May 21, 1979). Cf. 11 U.S.C.A.



### *Eligibility for Chapter 13*

Under Chapter XIII of the Bankruptcy Act, only individuals whose principal income was derived from wages, salaries, or commissions could seek relief.<sup>319</sup> Chapter 13 of title 11 has broadened eligibility to include any individual, but not a partnership or corporation, with a regular income<sup>320</sup> whose noncontingent, liquidated, unsecured debts are less than \$100,000 and whose noncontingent, liquidated, secured debts are less than \$350,000.<sup>321</sup> A joint petition may also be filed by an individual and his or her spouse if their debts do not exceed the amounts listed above, even if only one spouse receives regular income.<sup>322</sup> By eliminating the requirement that an individual need derive income principally from wages, salaries, or commissions, Congress has extended the possibility of Chapter 13 relief to more individuals, including those who own small businesses and for whom the more expensive and cumbersome arrangement proceedings of Chapter 11 would be inappropriate and undesirable. In keeping with the broadened eligibility of persons to use Chapter 13, its title has been changed from "Wage Earners' Plans" to "Adjustment of Debts of An Individual With Regular Income."

### *Protection of Codebtors*

Under Chapter XIII of the Bankruptcy Act, a creditor dissatisfied with extended installment payments under a plan could seek immediate full satisfaction of the debt from a codeb-

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§§ 706(c), 707 (West Spec. Pamp. 1979) (conversion from Chapter 7 to Chapter 13; dismissal of case initiated under Chapter 7). See SENATE REPORT, *supra* note 114, at 94, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5880; HOUSE REPORT, *supra* note 114, at 120, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6080-81.

319. Bankruptcy Act of 1898, ch. 541, § 606(8), added by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 931 (formerly 11 U.S.C. § 1006(8) (1976)). Courts in many jurisdictions have nevertheless confirmed plans where a regular source of income other than wages, salaries or commissions, such as income under public benefit plans, was available to fund the plan.

320. 11 U.S.C.A. § 109(e) (West Spec. Pamp. 1979). *Id.* § 101(24) defines "individual with regular income" as an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under Chapter 13 of this title, other than a stock broker or a commodity broker . . . ."

321. *Id.* § 109(e).

322. *Id.* §§ 109(e), 302. Even if an individual's spouse does not join in the filing of a petition for relief under Chapter 13, the discharge received by the spouse who files and who completes payments under the plan will protect the non-filing spouse against most creditors holding a community claim. *Id.* § 524(a)(3). See note 240 and accompanying text *supra*.

tor who had not sought relief under the Bankruptcy Act.<sup>323</sup> Such action by a creditor was likely to undermine the debtor's rehabilitation effort where the debtor would be pressured by the codebtor, often a relative or friend, to immediately pay the creditor in full to relieve the codebtor of any obligation.<sup>324</sup> Section 1301 of title 11 restricts this creditor practice.<sup>325</sup> A creditor may not seek to collect all or any part of a *consumer* debt<sup>326</sup> from a codebtor unless the codebtor became liable on or secured such debt in the ordinary course of such codebtor's business or unless the case has been closed, dismissed, or converted to a case under Chapter 7 or Chapter 11.<sup>327</sup>

*The Plan, Confirmation of the Plan, and Discharge*  
(Also See Addendum)

As under Chapter XIII of the Bankruptcy Act, the debtor under Chapter 13 may propose either an extension plan or a composition plan, to be implemented, generally, in three years, and in no event in more than five years.<sup>328</sup> Composition plans under Chapter XIII of the Bankruptcy Act were relatively rare in at least some jurisdictions, perhaps because a discharge granted after completion of payment under a composition plan would preclude discharge in a subsequent liquidation proceeding commenced within six years of the petition under Chapter XIII,<sup>329</sup> or because creditors would not accept such a plan,<sup>330</sup> or because a composition would not reflect a debtor's desire to pay debts in full. However, under Chapter 13 of title 11 there may very well be a large number of composition plans. Moreover, many of these compositions may be in the nature of a no asset or nominal asset liquidation (*e.g.*, creditors paid less than five percent of their claims) because, arguably, such a composition

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323. The automatic stay of Rule 13-401 protected only the debtor. Bankruptcy Rule 13-401, 11 U.S.C. app. at 1547 (1976).

324. HOUSE REPORT, *supra* note 114, at 121-22, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 6081-83.

325. 11 U.S.C.A. § 1301 (West Spec. Pamp. 1979); SENATE REPORT, *supra* note 114, at 138-39, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5924-25.

326. "Consumer debt" is a defined term. 11 U.S.C.A. § 101(7) (West Spec. Pamp. 1979).

327. A creditor may seek relief from this stay under specified circumstances. *Id.* § 1301(c).

328. *Id.* § 1322.

329. Bankruptcy Act of 1898, ch. 541, § 14, 30 Stat. 550 (as amended to § 14c(5)) (formerly U.S.C. § 32(c)(5) (1976)).

330. *Perry v. Commerce Loan Co.*, 383 U.S. at 395 n.4.

under Chapter 13 would avoid the disadvantages of a liquidation under Chapter 7.

Consider, for a moment, the major disadvantages to a Chapter 7 liquidation. First, a debtor will lose any property which may not be claimed exempt under section 522. While section 522 provides generous exemptions for the debtor in liquidation, there may be many cases in which a debtor either cannot or is not willing to convert non-exempt assets into exempt assets. For example, a debtor may have equity in a home which would far exceed any exempt amount, even utilizing California exemptions, and may be unwilling to mortgage the home (and protect the proceeds of the mortgage loan through investment in exempt property) in an amount sufficient to reduce the equity to the exempted amount. Second, a debtor may not be granted a discharge in a liquidation if the court finds to exist any of the grounds for denial or discharge listed in section 727. Third, the discharge to which a debtor would be entitled under Chapter 7 will not discharge the debtor's liability for specific kinds of debts, such as debts incurred through use of a false financial statement or by virtue of wilful and malicious conduct of the debtor.

It is possible to interpret the provisions of Chapter 13 to permit a debtor to propose and implement a plan where nothing or only a trivial sum is paid to unsecured creditors—the virtual equivalent of a no asset or nominal asset liquidation under Chapter 7—and which will avoid all of these disadvantages of a Chapter 7 liquidation! How, one may wonder, may this be accomplished and, if it can be accomplished, why would anyone ever wish to seek relief under Chapter 7?

The protests of unsecured creditors would be unavailing against such a plan. Unlike Chapter XIII of the Bankruptcy Act, unsecured creditors have no voice because the plan proposed by the debtor does not require their acceptance.<sup>331</sup> A plan must only provide for submission to the supervision and control of the trustee of as much of the debtor's future income as is necessary for the execution of the plan,<sup>332</sup> must provide for the payment in full, in deferred cash payments, of all priority claims, unless the holder of any such claim agrees to different

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331. Compare Bankruptcy Act of 1898, ch. 541, §§ 651-652 added by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 934 (formerly 11 U.S.C. §§ 1051-1052 (1976)) with 11 U.S.C.A. §§ 1325, 1327(a) (West Spec. Pamp. 1979).

332. 11 U.S.C.A. § 1322(a)(1) (West Spec. Pamp. 1979).

treatment,<sup>333</sup> and must treat claims within a class equally if the plan classifies claims.<sup>334</sup> While the plan may of course provide for full payment or substantial partial payment to unsecured creditors, it need not do so. Rather, a plan might in fact provide for zero or only nominal payment to unsecured creditors, if unsecured creditors would have received no dividend upon liquidation of the debtor's estate in a liquidation under Chapter 7.<sup>335</sup> All the debtor need establish to convince the court that unsecured creditors would have received no dividend in a liquidation under Chapter 7 is that all property of the debtor would have been exempt in liquidation, and that will be possible in most cases because most liquidation cases are no asset (or only nominal asset) cases.<sup>336</sup> To the extent that some property of the debtor would not have been exempt in a liquidation under Chapter 7, at least that much in value must be distributed to unsecured creditors under a Chapter 13 plan.<sup>337</sup>

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333. *Id.* § 1322(a)(2). Claims entitled to priority are those enumerated in section 507 of title 11. These include certain taxes owed governmental units, *id.* § 507(a)(6), but no longer include other debts owed the United States which are, by statute, entitled to priority. *Compare id.* § 507(a) with Bankruptcy Act of 1898, ch. 541, § 64, 30 Stat. 563 (as amended to § 64a(5)) (formerly 11 U.S.C. § 104(a)(5) (1976)). *Compare* 31 U.S.C.A. § 191 (West Supp. 1979) (as amended) (priority of debts owed the United States) with 31 U.S.C.A. § 191 (West 1976) (prior to amendment). Under Chapter XIII, plans were frequently not feasible or not acceptable to creditors because payment in full to priority claimants was required prior to disbursement to other creditors. Bankruptcy Act of 1898, ch. 541, § 659(6) added by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 935 (formerly 11 U.S.C. § 1059(6) (1976)). *See In re Belkin*, 358 F.2d 378 (6th Cir. 1966). More plans will be feasible under Chapter 13 both because claims, other than taxes, held by the United States are no longer entitled to priority and thus need not be paid in full under the plan, 11 U.S.C.A. §§ 507, 1322 (West Spec. Pamp. 1979), and because most claims (including tax claims) which do have priority under section 507, and which thus must be paid in full under the plan, need not be paid prior to payment of other claims. *Id.* § 1326.

334. *Id.* § 1322(a)(3).

335. *Id.* § 1325(a)(4).

336. *See, e.g., House Hearings, supra* note 8, at 767.

337. Even though a debtor must provide in a plan for payment to unsecured creditors of an amount not less than the value of non-exempt property of the debtor on the date of the filing of the petition under Chapter 13, the debtor still reaps the advantage of being able to keep that property because payments are to be made from future earnings (although the plan may provide for payment from other property, *id.* § 1322(b)(8)). The debtor, the court and other parties in interest will look to the debtor's claim of exemptions filed with the Chapter 13 Statement to determine the amount of minimum payment which must be made on account of the existence of non-exempt property. *See* note 308 *supra*.

A debtor might argue that no payment whatsoever is due unsecured creditors by virtue of the requirement of section 1325(a)(4) despite the existence of non-exempt property on the effective date of the plan if the debtor can show that conversion of such non-exempt property to exempt property *could have been made*. If that argument

If such a plan is confirmed by the court, unless otherwise provided in the plan or in the order confirming the plan, all property of the estate, not just exempt property, vests in the debtor and such property is free and clear of any claim or interest of any creditor provided for in the plan.<sup>338</sup> This feature of Chapter 13 is, of course, no different from Chapter XIII of the Bankruptcy Act.

In addition, if such a plan is confirmed and if the debtor completes all payments under the plan, the debtor is entitled to a discharge of all debts provided for by the plan except for certain long-term obligations and except for obligations to pay alimony and child support.<sup>339</sup> Section 1328(a) of title 11, which mandates this discharge, does not condition the discharge on the absence of any of the grounds for denial of discharge enumerated in section 727, and section 1328(a) permits the discharge even of the debts listed in section 523(a), such as those arising from wilful and malicious conduct of the debtor (but not for alimony and child support), which are excepted from discharge in a Chapter 7 liquidation.<sup>340</sup>

Thus, a composition in the nature of a no asset liquidation would appear to allow a debtor to pay unsecured creditors

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prevailed, a debtor could keep all of his or her property, whether or not actually exempt on the effective date of the plan, and propose a plan which would pay unsecured creditors nothing. The argument probably would not survive the language of section 1325(a)(4) which seems to suggest a payment to unsecured creditors based upon the value of non-exempt property which *actually does exist* on the effective date of the plan. In addition, a court might refuse to confirm such a plan on the grounds that it was not proposed in good faith. *Id.* § 1325(a)(3). See text accompanying notes 342-49 *infra*.

338. 11 U.S.C.A. § 1327(b)-(c) (West Spec. Pamp. 1979).

339. *Id.* § 1328.

340. *Id.* § 1328(a). If the debtor is granted a "hardship discharge" under section 1328(b) (payments under a plan can't be completed because of circumstances for which the debtor could not be held accountable and the plan can't be modified), the discharge does not discharge any of the debts excepted from discharge by section 523. *Id.* § 1328(b). This difference, between a discharge under section 1328(a) and a discharge under section 1328(b), may prove ironic, if not unfair. Thus, for example, a debtor who proposed to pay creditors in full in an extension plan and who makes payments equivalent to fifty percent of their claims prior to seeking and receiving a hardship discharge under section 1328(b) will not be discharged from debts excepted from discharge by section 523, but a person who completes a composition plan in which little or nothing was paid to creditors will receive a discharge which discharges all debts, including those excepted from discharge by section 523 (other than a debt for alimony and child support), except certain long term obligations dealt with by the plan under the authority of section 1322(b)(5). This possibility may be another factor supporting a court's denial of confirmation of a plan on the grounds that it was not proposed in good faith. See text accompanying notes 342-49 *infra*.

nothing, keep all of his or her property, receive a discharge even if he or she has committed acts which would bar discharge in a liquidation under Chapter 7, and the discharge would allow the debtor to escape paying all but one of the debts excepted from discharge in a liquidation under Chapter 7.<sup>341</sup> Could Congress have intended such a result?

There is precious little, but maybe just enough, language in Chapter 13 by which these consequences might be prevented. Under section 1325 of title 11, a court *must* confirm a plan if six conditions are fulfilled.<sup>342</sup> Among those conditions, the plan must be "proposed in good faith and not by any means forbidden by law."<sup>343</sup> One might argue, accordingly, that a plan such as that just described need not be confirmed by the court, because it is not proposed in good faith. If the plan is not confirmed, another must be submitted to avoid dismissal of the case or conversion of the case to Chapter 7 or Chapter 11.<sup>344</sup> Unfortunately, "good faith" is not defined in title 11 or in legislative history and one must therefore attempt to divine its meaning from its context, from prior interpretations of "good faith" in analogous provisions under the Bankruptcy Act, and from the relationship of Chapter 13 to Chapter 7 and to the overall structure and purpose of title 11.

Section 1325(a)(1) and (6) require, respectively, that the

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341. There would seemingly only be one deterrent to the filing of such a plan (other than the desire of the debtor to pay debts more fully). Under section 727(a)(9), a debtor would be precluded from receiving a discharge in a liquidation commenced within six years following the commencement of the case under Chapter 13 unless payments under the Chapter 13 totaled at least seventy percent of all allowed unsecured claims. 11 U.S.C.A. § 727(a)(9) (West Spec. Pamp. 1979). See text accompanying notes 231-32 *supra*. The Senate Judiciary Committee seemed to think that this would be an effective deterrent. Referring to the limitation on discharge ultimately enacted as section 727(a)(9), the Committee Report commented: "It is also necessary to prevent Chapter 13 plans from turning into mere offers of composition plans under which payments would equal only the non-exempt assets of the debtor." SENATE REPORT, *supra* note 114, at 13, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5799. However, given the potential advantages to the plan discussed in the text, the possibility of being precluded from discharge in a subsequent liquidation commenced within the six year period hardly seems much of a deterrent.

There might be one other possible deterrent to the proposal of a plan such as that discussed in the text. A debtor might feel that completion of such a plan would be less favorably viewed by persons from whom the debtor might later wish to seek credit. This, of course, assumes that such potential future creditors would understand the intricacies of relief under Chapter 13. Many creditors do not understand the nature of relief under Chapter XIII of the Bankruptcy Act.

342. 11 U.S.C.A. § 1325(a) (West Spec. Pamp. 1979).

343. *Id.* § 1325(a)(3).

344. See note 348 and accompanying text *infra*.

plan comply with the provisions of Chapter 13 (such as section 1322 governing the contents of the plan), and that the debtor be able to make all payments under the plan and comply with the plan (*i.e.*, that the plan be feasible). "Good faith" should, then, mean something different from the requirements of section 1325(a) (1) and (6) because otherwise the separate requirement of "good faith" listed in section 1325(a)(3) would be redundant.<sup>345</sup> "Good faith" might mean that the debtor in fact

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345. The logic of this argument is severely undercut by the history of the use and meaning of the phrase "good faith" in Chapters X, XI, XII, and XIII of the Bankruptcy Act of 1898, particularly if one heeds the admonition of the Supreme Court in an analagous context that one should "adhere to the familiar rule that where words are employed in an act which had at the time a well known meaning in the law, they are used in that sense unless the context requires the contrary." *Case v. Los Angeles Lumber Co.*, 308 U.S. 106, 115 (1939) (interpreting meaning of "fair, just and equitable"). In each of Chapters X, XI, XII, and XIII of the Bankruptcy Act of 1898, the requirement for confirmation of a plan that the plan be offered in good faith was stated separately from a requirement that the plan be feasible. Bankruptcy Act of 1898, ch. 541, § 221(2)-(3) *added by* Chandler Act of 1938, ch. 575, § 1, 52 Stat. 897 (formerly 11 U.S.C. § 621(2)-(3) (1976)) (Chap. X); *id.* § 366(2), (4) (formerly 11 U.S.C. § 766(2), (4) (1976)) (Chap. XI); *id.* § 472(2), (4) (formerly 11 U.S.C. § 872(2), (4) (1976)) (Chap. XII); *id.* § 656(2), (4) (formerly 11 U.S.C. § 1056(2), (4) (1976)) (Chap. XIII). In none of these chapters was the phrase "good faith" defined. Collier defined the phrase by stating that generally the courts' inquiry was "directed to whether or not there [had] been an abuse of the provisions, purpose or spirit of Chapter XIII in the proposal of a plan." 1A COLLIER BANKRUPTCY MANUAL ¶XIII-9.06[6], at 1408 (1978). That interpretation would support the broader reading of "good faith" suggested in the text, but the interpretation is not supported by any case law under Chapter XIII and is undermined by the case law interpreting "good faith" in Chapters X, XI, and XII. Interpretations of "good faith" in Chapters X, XI, and XII are directly applicable to interpretation of that phrase in Chapter XIII, *Hallenbeck v. Penn Mutual Life Ins. Co.*, 323 F.2d 566, 571 (4th Cir. 1963), *In re Garcia*, 396 F. Supp. 522, 524 (C.D. Cal. 1974), because the provision of "a means of relief and rehabilitation to debtors without adjudication as bankrupts was the common principal purpose of Chapter X, XI, XII and XIII of the Bankruptcy Act." 323 F.2d at 570.

Decisions under Chapter XI and XII indicated that, absent fraud or other egregious conduct by the debtor, the primary factor used in determining the debtor's "good faith" was whether the proposed plan was "feasible", *i.e.*, whether the debtor had sufficient means to effect the composition or extension. Salter, "Good Faith", 43 J. NAT'L CONF. REFEREES BANKR. 30 (1969) (Chap. XI); *Sumida v. Yumen*, 409 F.2d 654, 654 (9th Cir. 1969) ("good faith" means bona fide attempt to effect an arrangement by providing adequate means for execution of the plan) (dictum) (Chap. XII); *In re Bolton Hall Nursing Home*, 432 F. Supp. 528, 530-31 (D. Mass. 1977) (Chap. XIII).

There is nothing in the legislative history relating to the use of the phrase "good faith" in Chapter XIII which suggests a contrary view. The requirement of "good faith" was added to Chapter XIII (and to Chapters XI and XII) in 1952. Act of July 7, 1952, § 50, 66 Stat. 437. The House Report relating to that act simply stated that the test of good faith was substituted for the test "fair, just and equitable" because Supreme Court interpretation of "fair, just and equitable" made that language inappropriate other than in the context of a Chapter X. H.R. REP. No. 2320, 82d Cong., 2d Sess. 21, *reprinted in* [1952] U.S. CODE CONG. & AD. NEWS, 1960, 1981-82.

intends to complete payments under the plan (however minimal they might be) or it might mean that the debtor's motivations in proposing the plan are somehow pure or noble. If "good faith" simply refers to the intent of the debtor to complete payments under the plan, it would not be a basis for denying confirmation to the type of plan described above. If, however, "good faith" refers to the debtor's motives, the court could deny confirmation of such a plan on the ground that the debtor was seeking relief under Chapter 13 as a subterfuge for the discharge of debts without the disadvantages of Chapter 7. For it would appear almost preposterous to suppose that Congress intended Chapter 13 to be such an easy escape valve from Chapter 7 considering the thoroughness and care taken in evaluating the competing interests to be balanced in Chapter 7 and in drafting language to reflect the balance of interests which was struck.

Yet there are difficulties with these arguments. Cases under Chapters X, XI, XII, and XIII of the Bankruptcy Act construed "good faith" more narrowly.<sup>346</sup> Without clearer guidance in the language of title 11, that developed understanding of the phrase cannot lightly be dismissed, even more so because the language of section 1325(a)(4) requires only that payment to unsecured creditors under a plan not be less than the amount that would have been paid to such creditors had the debtor obtained relief under Chapter 7. If Congress wanted to require that compositions under Chapter 13 offer more to unsecured creditors, the language of section 1325(a)(4) would have been different. And if Congress wished to leave the amount of such payment to the sound discretion of the court, it could easily have included language which would have stated just that.<sup>347</sup>

Moreover, there are no standards articulated anywhere in title 11 or in the legislative history by which a court could measure a debtor's good faith if that meant measuring the debtor's motivations by reference to the elements of a plan. A court could, of course, ask whether income of the debtor potentially available for the plan exceeds the amount committed to the plan, but there is nothing to guide the court once the an-

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346. See note 345 *supra*.

347. For example, Congress might have required that a plan constitute a debtor's "best effort". Title 11 requires just that in another context. See text accompanying notes 231-32 *supra*.



swer to that question has been obtained. Must the debtor commit all of the available income to the plan? Surely not, because section 1322(a)(1) requires only that the debtor submit to the trustee so much of anticipated future income "as is necessary for the execution of the plan". Must the debtor commit half of available income to the plan, or twenty-five percent, or ten percent, to be in good faith? Since that question is so difficult to answer, some courts may simply eschew the inquiry and thus send a message to Congress that if this loophole in Chapter 13 is to be closed, Congress must close it.

There may be a middle position. A court might consider the amount of payment to unsecured creditors as only one factor relevant to a determination of good faith. A court might also consider the number, nature and extent of unsecured claims, including the claims which would be dischargeable under Chapter 13 but which would not be dischargeable under Chapter 7. Thus, a Chapter 13 composition in which little is to be paid to unsecured creditors and in which no unsecured creditor holds a claim that would be nondischargeable in a liquidation under Chapter 7 might be a plan proposed in good faith, whereas a similar composition affecting unsecured creditors with claims that are nondischargeable in a liquidation would not be in good faith. For the latter plan to be proposed in good faith, a court might require a composition which committed all or substantially all of the debtor's available income to the plan.

The court might further consider whether the proposed plan is sought despite the existence of facts which would preclude a discharge if the case were brought under Chapter 7. Thus, confirmation might be denied on the grounds of lack of good faith where the debtor commits little to the payment of unsecured creditors in a plan proposed only one year after the debtor has received a discharge in a Chapter 7 liquidation, because such a plan would frustrate the general policy of Congress to preclude the creation of a class of habitual bankrupts.

Given the uncertainty which exists concerning this vital issue, it seems important for attorneys to proceed cautiously in testing the limits of "good faith". Section 1307(c)(4) allows any party in interest to request that a case initiated under Chapter 13 be dismissed, or converted to Chapter 7, without the debtor's consent, if the court has denied confirmation of a plan and if the court has also denied additional time for filing an

alternate or modified plan.<sup>348</sup> If a court denies confirmation of a plan for lack of good faith on the grounds just discussed and if additional time for filing an alternate or modified plan is denied, the debtor may find himself or herself in an unwanted Chapter 7, resulting in the liquidation of non-exempt assets which it was his or her purpose to preserve through the use of Chapter 13.<sup>349</sup>

The uncertainty surrounding the meaning of "good faith" and the permissible bounds of Chapter 13 relief either belies the magnificent effort evident in the drafting of the Bankruptcy Reform Act, or reflects an untested assumption by the drafters that most persons will propose plans which approach their best effort, or reflects the intention of the drafters to move Chapter 13 far away from the original purposes of Chapter XIII of the Bankruptcy Act. If the last is true, I strongly suspect that those who voted for enactment of the Bankruptcy Reform Act failed to fully understand this particular intent of the drafters.

#### *Cram-down and Curing Defaults or Maintaining Payments on Long Term Obligations*

Chapter 13 of title 11 advances the cause of individual debtor protection in other ways. Most notably, Chapter 13 enables the debtor to cope more easily with secured debts than did Chapter XIII of the Bankruptcy Act. The most usual secured debts for the individual consumer debtor are debts owed personal property brokers secured by an interest in household goods and furnishings, debts owed a lender that is financing the acquisition of a motor vehicle, or debts secured by real property.

As noted earlier, a non-possessory, non-purchase money

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348. 11 U.S.C.A. § 1307(c)(4) (West Spec. Pamp. 1979).

349. Perhaps this possibility is remote. Assume, for example, that a debtor wishes to preserve \$5,000 of non-exempt equity in a residence (the debtor's only non-exempt property) through a Chapter 13 in which the claims of unsecured creditors total \$20,000. In such a case, the debtor's plan could not be confirmed, given section 1325(a)(4), unless the debtor committed at least \$5,000 (the amount which would be realized in a Chapter 7 liquidation) to the plan. It seems unlikely that a court would deny confirmation of such a plan on the grounds of lack of good faith unless \$5,000 were but a very small percentage of the income which the debtor could devote to the plan. \$5,000 would probably be more than a small percentage of available income because the debtor, unless an outright wealthy "deadbeat," would otherwise not need insolvency relief in the first place. Even were the court to deny confirmation, it seems likely that additional time to propose an alternative or modified plan would be granted.

security interest in household goods and furnishings can be avoided in a Chapter 7 liquidation;<sup>350</sup> such a security interest can also be avoided in a case under Chapter 13 because section 522(f)(2), which grants the power to avoid the fixing of such liens, applies to cases under Chapter 13 (as do all other provisions of Chapters 1, 3 and 5 of title 11).<sup>351</sup> Accordingly, creditors holding such security interests will lose their liens and be treated as unsecured creditors in any plan under Chapter 13.

Debts secured by an interest in a motor vehicle which the debtor needed to use to maintain his or her livelihood caused the most difficulty for debtors seeking relief under Chapter XIII of the Bankruptcy Act. One way or another the debtor was usually required to pay this secured creditor the full amount to which the creditor was entitled under the loan agreement to avoid losing the vehicle.<sup>352</sup> If there were insufficient funds to make this payment in addition to payments to the trustee for disbursement to other creditors, Chapter XIII relief by way of extension was not feasible; the debtor may have been compelled to file bankruptcy. Chapter 13 of title 11 provides succor to the debtor with this problem (or similar problems arising from secured debts involving other types of personal property collateral) by including the power to cram-down on secured creditors, a power formerly reserved to Chapters X and XII of the Bankruptcy Act. Section 1322(b)(2)<sup>353</sup> permits a debtor to propose a plan which modifies the rights of certain holders of secured claims and section 1325(a)(5), one of the six conditions for confirmation of a plan, requires only that the plan preserve the secured creditor's lien and that the plan provide for payment to the secured creditor of an amount not less than the amount of the allowed secured claim.<sup>354</sup> For example, if a debtor owed \$3,000 to a bank which held the pink slip to a motor

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350. See text accompanying notes 181-87 *supra*.

351. 11 U.S.C.A. § 103(a) (West Spec. Pamp. 1979). The important implications of the applicability of Chapters 1, 3 and 5 to Chapter 13 should not be overlooked. For example, the hypothetical debtors whose financial difficulties were discussed in the text accompanying notes 171-73 *supra* would be entitled to exercise precisely the same rights in a Chapter 13 proceeding that they were entitled to exercise under Chapter 7.

352. *But see* Thompson v. Ford Motor Credit Co., 475 F.2d 1217, 1218-19 (5th Cir. 1973) (referee may deny reclamation by secured creditor under Chap. XIII plan where general equitable considerations favor restraining foreclosure).

353. 11 U.S.C.A. § 1322(b)(2) (West Spec. Pamp. 1979).

354. *Id.* §§ 506(a), 1325(a)(5) (determination of secured status). Alternatively, the plan shall be confirmed if the secured creditor accepts the plan or if the debtor surrenders the collateral to the secured creditor.

vehicle registered to the debtor and the motor vehicle had a fair market value of \$1,000, the debtor's plan would be confirmed, assuming all other conditions for confirmation were fulfilled, if the plan provided for payment to the bank of \$1,000 during the period of the plan. If the plan extended over thirty six months, payment of the secured creditor would be slightly less than \$28 per month even though the loan agreement called for substantially larger monthly payments. Following completion of the plan, the debtor would keep the motor vehicle free and clear of the lien and the underlying debt will have been discharged.<sup>355</sup> The right of cram-down under section 1325(a)(5) is thus the functional analogue of the right of a debtor in a Chapter 7 liquidation to redeem certain property from a lien.<sup>356</sup>

Debts secured by an interest of the debtor in real property, usually the debtor's residence, may also be accommodated in a plan under Chapter 13, though not in the same way as other secured debts. This, too, is a change from Chapter XIII of the Bankruptcy Act in which no debt secured by an interest in real property could be treated by the plan.<sup>357</sup> Section 1322(b)(5) permits the debtor to propose a plan which will provide for the curing of defaults and the maintenance of payments on long-term obligations during the pendency of the case. This includes debts secured by an interest in real property, or an unsecured obligation such as an educational loan.<sup>358</sup> Thus, for example, a debtor facing imminent foreclosure under a deed of trust could file a petition for relief under Chapter 13, stay the foreclosure, and propose in the plan for payments to cure the default (within a reasonable time) and maintain the loan. Following completion of the plan, the debtor would then, of course, con-

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355. *Id.* §§ 1328(a) (discharge), 1327(c) (effect of confirmation).

356. See text accompanying notes 295-98 *supra*.

357. Bankruptcy Act of 1898, ch. 541, § 606(1), added by Chandler Act of 1938, ch. 575, § 1, 52 Stat. 930 (formerly 11 U.S.C. § 1006(1) (1976)).

358. 11 U.S.C.A. § 1322(b)(5) (West Spec. Pamp. 1979). The example of the educational loan is worth pursuing especially because such loans will generally not be dischargeable in a liquidation. See text accompanying notes 278-85 *supra*. Suppose that a debtor had scheduled repayment of a \$10,000 federally insured loan over a ten-year period with payments approximating \$100 per month. If the debtor wished to propose a five-year extension plan to pay all of the debtor's creditors, the debtor would need to shorten the repayment period for the educational loan from ten to five years and thus nearly double monthly payments on account of that debt alone. That necessity might make the plan impossible of performance. Section 1322(b)(5) permits the debtor to propose a five-year extension plan under which all other creditors are paid in full and under which payments on the educational loan may be continued at the rate of \$100 per month.

tinue payments on the obligation.<sup>359</sup> The ability of the debtor to provide for the real property secured debt in this way is a decided advantage over Chapter XIII of the Bankruptcy Act under which the filing of a petition would only stall the foreclosure until the creditor obtained relief from the automatic stay, an event which could usually only be avoided if the debtor secured a purchaser for the real property or obtained refinancing.

In contrast to other novelties of Chapter 13, the expanded eligibility for relief, the power to stay action against co-debtors, the right to cram-down on certain secured creditors and the right to cure defaults and maintain payments on long-term obligations were clearly contemplated by the drafters of Chapter 13 and there should be little difficulty in their application. Irrespective of the resolution of the issue of "good faith", these changes will certainly make relief under Chapter 13 a valuable tool for insolvency counseling in the 1980's.

#### CONCLUSION

The outlines and much of the detail of consumer insolvency counseling for Californians in the 1980's have been provided us in the late 1970's by Congress and by the California legislature. There will be some changes, of course. The federal Fair Debt Collection Practices Act may be extended to govern the actions of creditors collecting debts on their own behalf. Further restrictions upon the amount of wages of a debtor which can be garnished, such as those proposed by the California Law Revision Commission, may finally gain legislative approval. There will be changes in the amounts of property exempt in bankruptcy as the country endures inflation and there may very well be changes in the kinds of property exempt if the California legislature adopts provisions of the working proposals of the California Law Revision Commission concerning California's enforcement of judgment law. In addition, retroactive application of increases in exempt amounts to pre-increase creditors may finally surmount its constitutional hurdle. There most certainly will be judicial construction and possibly congressional amendment of the apparently over-generous debtor relief measures of Chapter 13 of title 11. And,

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359. Debts provided for under section 1322(b)(5) are not subject to the general discharge of section 1328. *Id.* §§ 1328(a)(1)-(c)(1).

perhaps, the pattern and amount of consumer credit, especially credit advanced by personal property brokers, may shift to accommodate and adjust to those provisions of the new bankruptcy law which strengthen the debtor's ability to gain a post-petition fresh start.

The need for consumer insolvency counseling will almost certainly increase in the decade of the 1980's as economic dislocations result from the nation's search for and shift to new forms of energy and as the demand for and use of consumer credit continues to grow.<sup>360</sup> Attorneys who are well informed about the tools of insolvency counseling and who can lend compassion and understanding to their counseling will play a valuable role in fulfilling that need.

#### ADDENDUM

During final preparation of this article for publication, the Senate Judiciary Committee favorably reported an amended version of S. 658, the Technical Amendments bill.<sup>361</sup> This amended version of S. 658, to take effect, if passed, on October 1, 1979, includes two very important amendments to title 11 which were not included in the original version of S. 658. Section 188 of the amended bill would amend section 1325(a)(3) of title 11 to require that a debtor's Chapter 13 plan be a debtor's best effort in addition to being proposed in good faith.<sup>362</sup> Section 191 of the amended bill would amend section 1328(a)(2) of title 11 such that a completed Chapter 13 plan would not discharge any debts which would be nondischargeable in a liquidation.<sup>363</sup> These two changes would close the apparant gaping Chapter 13 loopholes described in the article. While these changes hardly seem consistent with the stated purpose of S. 658 "[t]o correct technical errors, clarify and make minor substantive changes to Public Law 95-598,"<sup>364</sup> they probably are consistent with the prevailing congressional view about the nature and purpose of Chapter 13 relief.

The amended version of S. 658 also includes the proposed

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360. In the 1980's, the size of the population aged 35 to 44 will grow from approximately 28 to 40 million. The persons in that age range are major users of credit. *TIME*, May 28, 1979, at 39.

361. S. REP. No. 305, 96th Cong., 1st Sess. 1 (1979).

362. *Id.* at 14.

363. *Id.*

364. *Id.* at 1.

amendment to title 11 referred to in footnote 125.<sup>365</sup> In addition, sections 130b and 221 of S. 658 would revive prior law that claims for alimony are nondischargeable despite assignment to a state welfare agency as a condition of the extension of welfare benefits.<sup>366</sup> Section 218 of S. 658 would amend the Fair Credit Reporting Act to prohibit the reporting of Chapter 13 relief subsequent to seven years following the filing of the petition for relief.<sup>367</sup>

H.R. 2807,<sup>368</sup> concerning the dischargeability of educational loans, was signed by the President on August 14, 1979, as Public Law 96-56. It was effective immediately. H.R. 2807 also amended the definition of educational loans in section 523(a)(8) of title 11.

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365. See discussion of the Technical Amendments Act in note 125 *supra*.

366. See discussion of the Technical Amendments Act in note 267 *supra*.

367. Contrast the discussion in paragraph 4 of note 113 *supra*.

368. Referred to in note 284 *supra*.