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Consumer Lending and the Bankruptcy Reform Act of 1978

by K.J. Kowalewski

The Bankruptcy Reform Act of 1978, effective October 1, 1979, is the first complete revision of U.S. bankruptcy law since 1898. Since that time, the enormous growth of the consumer credit industry has paralleled that of the number of consumer bankruptcies. The increase in consumer bankruptcies has placed great strain on the bankruptcy court system, while the diversity and number of consumer debt instruments have made the equitable administration of consumer bankruptcy cases more difficult. The equity issue involves not only rehabilitation of consumer debtors and their right to a "fresh start," but also the right of creditors to equitable distribution of a debtor's estate.[1] Apart from important administrative changes in the U.S. bankruptcy courts, the major changes in the new bankruptcy code address this equity issue; specifically, they relate to valuation of a debtor's estate and actions creditors can take against debtors.

The scope and nature of these changes have altered the potential loan losses for consumer lenders. Loan loss per bankrupt client and the total number of bankruptcy filings have risen significantly in the past year. In the year ending June 30, 1980, the total number of nonbusiness bankruptcies in the United States rose to an all-time high—22.7 percent higher than in the previous year and 7.8 percent higher than the previous high in 1975. Comprehensive statistics on the loan loss experience of creditors are, however, not as yet available.[2] Much of the increase in nonbusiness bankruptcies can be attributed to

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1. An *estate* is the debtor's net worth adjusted for the provisions in the bankruptcy code.

2. For the first nine months of 1980, Household Finance Corporation reported that its bankruptcy charge-off was 40.3 percent of its total loan charge-off. Its highest annual bankruptcy charge-off percentage was 37.6 percent in 1971.

changing attitudes toward bankruptcy, advertising by lawyers, the economic slowdown during the second quarter of 1980, and the deterioration of consumer balance sheets; the new bankruptcy code may also be partly responsible for the increased number of bankruptcies. This *Economic Commentary* examines the major changes of the new bankruptcy code and the potential reaction of consumer lenders.

Major Provisions of the New Bankruptcy Code

Consumer debtors continue to have two voluntary bankruptcy options under the new bankruptcy code—liquidation under Chapter 7 and rehabilitation under Chapter 13.[3] Any consumer debtor can voluntarily file for a liquidation or straight bankruptcy if he has not filed for such a bankruptcy in the previous six years, although he may file within six years of a previous Chapter 13 bankruptcy. Under liquidation, debtors relinquish all nonexempt assets to creditors in return for a discharge from all allowable debts. To qualify for a rehabilitation bankruptcy, a debtor must have a regular income, unsecured debt totaling less than $100,000, and secured debt totaling less than $350,000. Unlike liquidation, Chapter 13 individuals do not surrender nonexempt assets to creditors for distribution. Instead, debts are paid over time out of future income; when payments are completed, a debtor is discharged from all debts covered under the plan. The basic criterion of a Chapter 13 bankruptcy is that all creditors must be at least as well off as they would have been had a debtor filed a Chapter 7 bankruptcy.

A major provision broadened under the new code is the *automatic stay*; this provision significantly circumscribes creditor action against debtors once a bankruptcy petition is filed. The automatic stay under the former law did not prevent certain creditors from taking certain actions that gave them an unfair advantage over other creditors in the dissolution of a debtor's estate. The automatic stay under the new code promotes equitable treatment of all creditors by preventing their beginning or continuing (without court approval) *any* act of lien enforcement, repossession of a debtor's property, confiscation of a debtor's demand, savings, or time deposits (called *setoff*), acceleration of debt repayments, reaffirmation, or other alteration of a loan agreement. In addition, the new stay applies to all property of a debtor, regardless of who possesses it or who holds the record title. When the bankruptcy courts have a backlog of cases, as they do now, the automatic stay permits a debtor to retain possession of the collateral—at least until the bankruptcy plan is settled.

The new stay unquestionably alters the rights of creditors. As a result, certain limitations are placed on the continuance of the stay. For secured lenders, the new code introduces the concept of "adequate protection." Although the bankruptcy court has the right to change the terms of a secured

3. Consumer debtors also may be involuntarily placed in straight bankruptcy if a (bankruptcy) petition is filed by at least three creditors or by at least one creditor if there are fewer than twelve, and if the total value of the creditors' claims sum to at least $5,000. The filing of involuntary bankruptcy is made easier under the new code.

loan, it cannot deny a lender the value of his interest in a loan. Thus, if the court modifies a secured loan contract, a secured lender is to be "reimbursed" for his lost value by receiving: a) periodic payments from a debtor in cash, b) additional or replacement liens on other property, or c) some other relief. The reimbursement, of course, is limited to the extent of the decrease in the value of his interest. Moreover, any creditor may request the court for relief from the stay if he feels that he will be irreparably harmed by it. If a creditor believes that the collateral value is too low, he must prove this to the court. Otherwise, a debtor must prove that the stay is necessary.

The new code also restricts some actions taken by creditors before the bankruptcy petition is filed. Setoffs are one example. When a creditor takes a setoff within 90 days of filing, a debtor may recover a creditor's improvement of position between the 90th day prior to filing of the bankruptcy petition and the date of the setoff. For example, suppose that a debtor owes $1,000 to a bank 90 days prior to filing and that there is $100 in his bank account at that time. On the day before filing, $1,000 is still owed, but there is $900 in the debtor's bank account. If the bank takes the setoff when there is $100 in the account, the setoff is valid. If the bank takes the setoff when there is $900 in the account, however, the bank improves its position by $800 and the debtor can try to recover the $800.

The new code also places tighter reins on preferences. A *preference* is any transfer of any property interest (including cash or security interest, for example) to a creditor or for his benefit; the transfer must be made within 90 days before the date of bankruptcy while the debtor was insolvent, and it must enable a creditor to receive more than he would have received in the bankruptcy proceeding without the transfer. In the past, a creditor could threaten wage garnishment or repossession to force a debtor, before he filed for bankruptcy, to pay some amount of money, thereby favoring one creditor over others. Considering the exclusions to the preference provision in the new code, a debtor can in effect recover payments made to creditors within 90 days prior to bankruptcy and beyond 45 days after a loan was made. However, to the extent that the creditor is over-secured, payments received within 90 days will not be considered a preference.

Actions that unsecured creditors can take continue to be severely restricted under the new code; unsecured claims continue to be subordinated to secured claims. The automatic stay generally stops interest on all unsecured debt, but if a debtor is solvent, interest is paid at the legal rate. In a Chapter 7 bankruptcy, co-debtors can be pursued without court permission; but in a Chapter 13 bankruptcy, co-debtors usually can be pursued only if the plan does not propose full repayment of unsecured debt. In addition, unsecured creditors have no say in the confirmation of a Chapter 13 bankruptcy.

The other major changes of the new code relate mainly to the valuation of a debtor's estate and hence the "fresh start" available to a debtor. These include the valuation of secured claims, exemption levels, redemptions, reaffirmations, and discharges. If the amount of a secured debt in some property is greater than the collateral value of that property, a creditor

has a secured claim only for the collateral value and an unsecured claim for the excess. That is, the present value of the secured claim is only the collateral value. If the collateral value is greater than the amount of secured debt, then a creditor will be allowed interest on the claim at the contract rate plus any agreed upon fees.

A new set of federal exemption levels has been introduced in the new code. The former law permitted only state exemption levels, which had not been revised to reflect the recent inflation experience in the United States. The new code allows debtors to choose either federal or state exemption levels, unless state law permits only state exemption levels. Using federal exemption levels, a consumer debtor can exempt from the value of his estate $7,900 equity in any property (of which $7,500 may be a homestead or burial plot), $1,200 equity in one motor vehicle, $500 equity in jewelry, $4,000 equity in cash surrender value of life insurance policies, an unlimited amount of equity in professionally prescribed health aids, and miscellaneous public benefits and injury awards. As long as property is held primarily for immediate family or household use of a debtor or his dependents, a debtor also may exempt up to $200 in equity for any number of items in the following categories: household furnishings and goods, wearing apparel, appliances, books, animals, crops, and musical instruments. Finally, a debtor may exempt an equity of up to $750 total in implements, professional books, or tools of his trade or that of his dependents. If a husband and wife file a joint-bankruptcy petition, two sets of exemptions may be taken.[4] Judicial liens and nonpurchase money security interests in household goods, books, or tools of a debtor's trade or in professionally prescribed health aids may be avoided in order to enforce these exemptions.[5]

A related provision concerns redemption. A debtor may redeem tangible personal property from a lien securing a dischargeable consumer debt if such property is declared exempt or has been properly abandoned, by paying the lienholder the lesser of the collateral value or the amount of the debt.

Although the automatic stay restricts actions that creditors can take to obtain reaffirmations from debtors, debtors may voluntarily reaffirm debts; the reaffirmation must be made before the debt is discharged and may be rescinded by a debtor within 30 days after court approval.

4. As a comparison, Ohio exemptions include $5,000 in a homestead, $1,000 in a motor vehicle, $750 in tools of trade, $400 in money, and $1,500 in household goods including jewelry (if the homestead exemption is claimed, $2,000 otherwise; no one household good may be worth $200, although a stove and refrigerator may each be worth at most $500). In addition, all prescribed health aids and $2,500 of a future personal injury award may be exempted.

5. A nonpurchase money security interest is a lien made on an item put up for collateral but not the item actually purchased with the loan. Consumer finance companies typically use this type of security interest. In the future, creditors will need to take purchase money security interest in these items to sidestep this provision.

Finally, when the bankruptcy plan is approved or the payments under a Chapter 13 bankruptcy are complete, all debts (with several exceptions) of a debtor are discharged. Once discharged, no further act may be commenced or continued to collect any discharged debt from a debtor or his property. This strengthens the provision of the former law to ensure that a debtor will not be pressured into repaying a debt (once it has been discharged). With a few exceptions, the injunction also protects the debtor's community property acquired after commencement of the case.

Lender Reaction to Recent Consumer Bankruptcy Experience

When the new code went into effect, creditors were unable to assess its impact. The code is very complex, and its intention appeared to treat creditors and debtors more equitably. Since implementation of the code, creditors have become virtually unanimous in their beliefs that the new code favors debtors over creditors to a greater extent than the previous law. Although it is clear that the ability to negate certain nonpurchase money security interests favors debtors over creditors, the net effect of the other provisions is not clear. Six states, including Ohio, have overridden the federal exemption levels with their own lower exemption levels. In other states, the differences between state and federal exemption levels most likely favor some creditors more than others, depending on which set of exemptions a debtor chooses. The new restrictions on actions that creditors can take against debtors unquestionably favor debtors over creditors, but their relative influence on creditors is again unclear.[6] Some creditors are no longer able to take certain actions, but other creditors are better able to protect their interests. The new setoff provisions, for example, favor creditors that are not also depository institutions. Furthermore, all creditors may be better off if the new code eventually succeeds in promoting repayment rather than liquidation.

It is too soon for anyone to have made a careful study of the impact of the new code on consumer bankruptcies. However, such studies will be required both for policymakers to correct deficiencies in the new code and for creditors to adjust consumer lending policies. If the new code has artificially encouraged bankruptcy filings, reform of the code will be required and creditors probably need not modify their lending practices. If the root of the problem goes deeper, other steps will be necessary. For example, many people argue that the amount of consumer credit has been too abundant in recent years, allowing consumers to over-extend themselves too easily. When an economic slowdown occurs, consumers are severely constrained by highly levered balance sheets. In this case, creditors must tighten loan requirements for all consumers or at least for those consumers whose financial positions fluctuate with business cycles. Data on individual consumer debtors, as well as aggregate statistics on all consumers, need to be assembled and studied to recommend the appropriate creditor and/or policy responses.

6. Strategies for minimizing loan losses when involved in a bankruptcy case can be found in Kenneth N. Klee, "A Lending Officer's Primer on the New Bankruptcy Code," *Banking Law Journal,* vol. 97 (May 1980), pp. 388-425; and William P. Mapother, "Bankruptcy Strategies for Consumer Creditors," *Credit,* vol. 6 (November/December 1980), pp. 15-17.

Conversations with bankers in the Fourth District suggest that careful examination of the causes of their consumer loan losses has not yet been undertaken. Few have compiled figures on loan losses due to bankruptcy or identified the characteristics of their bankrupt clients. Bankers agree, however, that the new code has increased consumer loan losses and that lending practices would be changed as a result.

Of the intended changes, many banks plan to extend less credit—by requiring larger down payments, making fewer loans, eliminating student loans, using stricter loan requirements (especially for persons with previous bankruptcies), and eliminating indirect lending. Others indicated that they would increase loan interest rates where possible, institute late payment fees on credit cards, and make variable rate loans.

Conclusion

Whether or not the new code is responsible for the increased number of bankruptcies, creditors are preparing to alter their consumer lending practices. If the code is totally or even partly responsible, it should be amended. If the new code is only partly or not responsible, bankruptcy experience may be an indication of a misallocation of resources—an over-supply of loans to the consumer sector that only tightened credit policies can remedy.

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