

*This is an annotated version of an article that appeared in two parts in the May and June, 2005, issues of ILLINOIS WELFARE NEWS. It provides some additional details, and includes citations to the new bankruptcy law. The author, David Yen, is an attorney at the Legal Assistance Foundation of Chicago.*

*This article was originally written for advocates in Illinois. Differences in state law and local practice should be taken into account when advising clients in other jurisdictions.*

## **Reasons for Low- and Moderate-Income Debtors to File for Bankruptcy Now Before the Law Changes**

By David Yen

The new bankruptcy law, Public Law No. 109-8, was signed by President Bush on April 20. The changes that affect low- and moderate-income debtors in Illinois apply to cases filed on or after October 17, 2005 (180 days after enactment)<sup>1</sup>. As mentioned in my article in the March 2005 issue of ILLINOIS WELFARE NEWS (“Don’t Believe the Hype: Bankruptcy Bill Will Harm Low- and Moderate-Income Debtors”), the much-discussed “means test” will force some debtors whose income is more than the median income in their state into Chapter 13 instead of Chapter 7 bankruptcy. However, many provisions will affect low- and moderate-income debtors who do not have to worry about failing the means test. Below are some situations where a debtor should consider filing for bankruptcy before the changes go into effect.

**Debtor has public benefits overpayments that are alleged to be fraudulent.** Elimination of the Chapter 13 “superdischarge” for debts incurred by fraud<sup>2</sup> means that (a) if overpayment was fraudulent, it will not be discharged in a Chapter 13 plan; (b) even if it was not, debtor may have to rebut a claim that the overpayment was fraudulent or else the debt will not be discharged in Chapter 13. Many debtors cannot afford the legal fees needed to show that the overpayment was not the result of fraud. Under existing law, debts incurred by fraud are discharged when a debtor successfully completes a Chapter 13 plan even if the debts were not paid in full. This means that the debtor who files a Chapter 13 plan in good faith does not have to litigate the issue of fraud. Since debts incurred by fraud will no longer be discharged in a Chapter 13 case, if the debtor cannot rebut an accusation that the debt was the result of fraud, the debtor will have to pay 100 percent of all debts in order to get a discharge.<sup>3</sup>

**Debtor owes money to utilities or other creditors due to alleged fraud, theft, embezzlement or a willful and malicious tort which caused personal injury or death but which was not the result of drunk driving.** Elimination of the Chapter 13 superdischarge<sup>4</sup> also applies to these debts. (Debts resulting from drunk driving were already not dischargeable in either a Chapter 7 or a Chapter 13 bankruptcy)<sup>5</sup>. Debtors frequently have problems proving that these debts should be discharged since a trial may be required, the debts may be old, and the creditor may have better records and more resources. The consequences can be dire. If a utility claims that service was stolen and the debtor cannot rebut the charge, the debtor will have to pay 100 percent of all debts in order to get a Chapter 13 discharge.<sup>6</sup> If the debtor does not have enough income to do this, then the debtor may not be able to obtain a Section 8 voucher. A debtor who has a large, nondischargeable tort judgment arising out of willful and malicious conduct may be faced with 20 years of wage garnishments.

**Debtor is “upside down” on a car purchased after April 21, 2003.** A debtor is “upside down” on a car when the debtor owes more than the car is worth. Under existing law, the debtor can “strip down” any debt where the value of the collateral is less than the amount owed.<sup>7</sup> The debtor pays 100 percent of the value of the collateral, with interest, and the difference between the value of the collateral and the amount owed is paid along with other unsecured debts, without interest, usually at much less than 100 percent. The new law eliminates a debtor’s ability to strip down a loan that was used to finance the purchase of a vehicle within 910 days before the filing date.<sup>8</sup> If a car was purchased before April 21, 2003, the debtor will still be able to strip down the loan. However, if the car was purchased after April 21, 2003, and the case is filed after the new law becomes effective, the debtor will have to wait until it has been more than 910 days since the car was purchased to strip down the loan. If the loan has a very high interest rate, the debtor may be able to reduce the interest rate by filing for Chapter 13, but the debtor will not be able to reduce the amount that has to be repaid to reflect the real value of the car. This is not limited to new cars—it applies to used cars purchased by the debtor as well.

**Debtor received a discharge in a case filed between October 17, 1997, and October 16, 1999, and is in need of Chapter 7 bankruptcy relief.** The time between Chapter 7 discharges has been extended from six years to eight years.<sup>9</sup> This means that the debtor who got a Chapter 7 discharge during this period may get a discharge if a case was filed within six years and before the new law goes into effect but would have to wait up to two additional years if the debtor does not file before October 17, 2005.

**Debtor received a Chapter 7 discharge after October 17, 2001, or a Chapter 13 discharge after October 17, 2003, and is in need of Chapter 13 bankruptcy relief.** Under current law even if the debtor has recently received a bankruptcy discharge, the debtor may still file for Chapter 13, and as long as a plan is filed in good faith and meets other requirements for confirmation, the debtor may confirm a Chapter 13 plan even if the plan pays less than 100 percent as long as the plan represents the debtor’s best efforts to repay the debts for at least three years. This may preserve or reinstate a driver’s license needed for employment, preserve or restore essential utility service, protect wages from garnishment, or prevent recoupment or offset of public benefits. The new law says that if the debtor received a Chapter 7 discharge within the previous four years or a Chapter 13 discharge within the previous two years, the debtor may not get a Chapter 13 discharge.<sup>10</sup> The debtor would either have to wait until the time period passed to be able to file for Chapter 13 or would have to propose a plan that would pay 100 percent of unsecured debt, with interest, and this may be beyond the debtor’s ability to pay. A debtor who needs to file for a Chapter 13 bankruptcy to stop a mortgage foreclosure may still do so<sup>11</sup>, but such a filing may be more expensive if the debtor also owes other debts.

**Debtor is ineligible for free legal services<sup>12</sup> and, while currently judgment-proof, has health insurance, is employable, and may earn garnishable wages in the future.** Under current law, a debtor who is not able to obtain free legal services but is struggling financially may be able to afford fees charged by a private attorney to file for a Chapter 7 bankruptcy. Once the new law goes into effect, attorney fees are going to increase because of increased paperwork needed to file for a bankruptcy and new rules that will make attorneys liable if documents filed in the case turn out to be inaccurate. The new law will require credit counseling before a case is filed and completion of a financial education course in order to get a discharge. While credit counseling and financial education have to be provided without charge to those who cannot

afford to pay, debtors who have too much income for free legal services are likely to have to pay these fees. There are many new requirements, such as a requirement to file copies of tax returns or tax transcripts that will make it harder for debtors who file *pro se* to complete a case. The filing fee is also going to increase from \$209 to at least \$274. In the past this debtor might decide to wait to file for bankruptcy since there is no immediate reason to file. However, if this debtor waits, at the least filing for bankruptcy will be more expensive. In the worst-case scenario, the debtor may never be able to file for bankruptcy once the law changes because the debtor cannot save enough money to get the bankruptcy filed.

**Debtor has a student loan which is owed to a for-profit entity and which debtor cannot repay.** The new law extends the student loan exception to discharge to educational loans made by for-profit entities.<sup>13</sup> This may include loans that are made by a debtor's employer and that the debtor is expected to repay in addition to those made by for-profit trade schools.

**Debtor owes a substantial amount of child support that has been assigned to someone other than the parent, legal guardian, or responsible relative of the child, the spouse or ex-spouse of the debtor, or the child and will be filing for a Chapter 13 bankruptcy.** While never dischargeable in any kind of bankruptcy under current law, child support that has been assigned to a third party, such as the state child support agency, does not have to be paid in full during a Chapter 13 case. The Chapter 13 debtor must completely catch up on child support obligations to the custodial parent, but support that has been assigned to the state does not have to be paid in full during the Chapter 13 plan. The debtor pays as much as possible, and the rest will be paid after the Chapter 13 case is over, usually in three years. Under the new law, the debtor will have to pay all child support in full or, if that is not possible, will have to be in Chapter 13 for five years.<sup>14</sup>

**Debtor has been convicted of a crime of violence or a drug-trafficking felony and does not have reasonable prospects of being able to complete a Chapter 13 case in the near future.** The new law adds a section which provides that if the debtor files a voluntary Chapter 7 petition but has been convicted of a crime of violence or a drug-trafficking felony, the case will be dismissed when dismissal is in the best interest of a victim of the debtor, unless the filing of the case is necessary to satisfy a child support, alimony, or maintenance obligation of the debtor.<sup>15</sup> This is especially problematic if the debtor has been convicted of a "drug-trafficking crime" since who would have standing to object to the case as a victim of the drug-trafficking crime is not at all clear. May the state's attorney object? How about a relative of someone who purchased drugs from the debtor? While there are certainly some cases where justice would be served by denying a Chapter 7 discharge, in other cases this could interfere with an ex-offender's rehabilitation efforts.

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1. There are some changes which are immediately effective. These limit the homestead exemption to \$125,000 where the debtor has moved to a state with high homestead exemptions, or where the debtor has been guilty of certain kinds of corporate malfeasance. Since the Illinois

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homestead exemption is only \$7,500, they would almost never apply.

2. Pub.L. 109-8 314(b)(2); new code § 1328(a)(2).

3. Because interest continues to accrue on nondischargeable debts, once the debtor has paid 100% of all debts, he or she will then have to continue to make payments under the plan until the interest on the nondischargeable debt has been paid. See Pub.L. 109-8 213(9); new code § 1322(a)(10)

4. See note 2, *supra*.

5. Drunk driving debts - see §523(a)(9) are not covered by the Chapter 13 discharge. Existing code 1328(a)(2).

6. A substantial body of case law holds that a debtor cannot separately classify a debt and pay 100% of that debt, while paying a small percentage to all other general unsecured debts, merely because the debt is nondischargeable in a Chapter 13. It is *possible* that a court might allow a separate classification for utility debt on the grounds that it benefits all creditors for the debtor to have utility service, and thus be able to live. If the debtor is not allowed to discriminate in this manner, the debtor would have to pay 100% of all debts in order to be able to use section 366 of the Code to discharge the utility debt. The debtor will also have to pay interest on the debt. See note 3 *supra*.

7. Code § 506(a). Northern District of Illinois Model Plan, ¶s B.3, second option, and E.5

8. Pub.L. 109-8 § 306(b); new code § 1325(a), following § 1325(a)(9). Pub.L. 109-8 also limits strip down of security interests in property other than motor vehicles where the debt was incurred within the year before the bankruptcy was filed.

9. Pub.L. 109-8 § 312(1); new code § 727(a)(8). The waiting period to file a Chapter 7 after a Chapter 13 where the debtor paid less than 70% of unsecured debts is still 6 years. 11 U.S.C. § 727(a)(9).

10. Pub.L. 109-8 § 312(2) ; new code § 1328(f). As Judge Wedoff's outline notes the language in this section is ambiguous.

It denies discharge in a Chapter 13 case if some triggering event occurred during the two- or four-year period before the case was filed, but it does not clearly identify that event. The triggering event could be either the *filing* of a prior bankruptcy case that resulted in a discharge or the *receipt of a discharge* in the prior case. Since the first verb before the phrase "during the . . . period" is "filed," the grammatically correct interpretation is that discharge is denied if the prior case was "*filed* [under the relevant chapter] during the [2- or 4-year] period preceding the date of the order for relief." However, it is possible to read the provision as applying "if the debtor *received a discharge* [in a case filed under the relevant chapter] during the . . . period." Policy arguments and legislative history

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might be advanced in support of the latter interpretation.

Wedoff, *Major Effects of the Consumer Provisions of the 2005 Bankruptcy Reform Legislation*, at 7, fn.1. The safer course is to assume that the interpretation which is grammatically incorrect is the one which will ultimately be adopted.

11. In chapter 13 cases to stop mortgage foreclosures, the debtor almost always pays the arrears in full, and reinstates the mortgage. *See* 11 U.S.C. § 1322(b)(5). When a long term debt, such as a mortgage, is reinstated in a Chapter 13 case, that debt is not discharged. 11 U.S.C. § 1328(a)(1).

12. If the debtor is eligible for free legal services and judgment proof, we would probably still advise the client not to file, to save the option of filing bankruptcy in case it is needed later. If the client “wastes” the right to file bankruptcy, and then runs into financial problems later, the client will have to wait 8 years instead of 6 years.

13. Pub.L. 109-8 § 220; new code § 523(a)(8)(B).

14. Pub.L. 109-8 § 213(8); new code § 1322(a)(4).

15. Pub.L. 109-8 § 102(f); new code § 707(c). This section only applies to Chapter 7 cases, so if the client could complete a Chapter 13 plan, this section does not preclude the client from bankruptcy relief.