

The American BANKRUPTCY LAW JOURNAL

*A Quarterly Journal of the National Conference of
Bankruptcy Judges*



VOLUME 71

FALL 1997

Restructuring Individual Debts

by

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The National Conference of Bankruptcy Judges asked me to present a proposal at the 1996 annual conference dealing with restructuring individual debts. This Article is a revision of that proposal.

A comprehensive, thoughtful proposal on this topic requires a short book, or at the very least a series of articles. Nevertheless, this Article permits us to tackle the topic from a broad philosophical perspective. Once we agree on the general approach, the details can follow. This Article assumes that the reader is familiar with individual debt restructuring problems in the United States and the data pertaining to those problems. To place the proposal in context, however, a brief outline of the chapters that would be included in a book on this topic is in order.

Chapter One defines the scope of individual debt restructuring and develops the history of individual debt restructuring from cave dwellers through the Code of Hammurabi, the Roman Law of the Twelve Tables, Dutch Mercantile Law, English debtors' prisons, and the American Bankruptcy Act of 1898.¹ This chapter develops the different kinds of debts that have been restructured over the years, ranging from contract and tort debts to civil and criminal governmental obligations. Chapter One concludes that the purposes of individual debt restructuring have changed over time.

Chapter Two explores modern approaches to individual debt restructuring around the world. Western European approaches are contrasted with Asian and Muslim views on the subject. This chapter concludes that there are a few basic conflicting modern goals that are balanced differently, depending on religious, cultural, and political values in each society. In particular, societies that restrict access to consumer credit often restrict access to bankruptcy, because there is no broad societal need for debtors to get a fresh start. Likewise, societies with broad social safety nets adopt restrictive bankruptcy laws, because bankruptcy is not precipitated by health bills or loss of employment. On the other hand, countries with massive amounts of consumer

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¹Bankruptcy Act of 1898, Pub. L. No. 55-171, 30 Stat. 544 (repealed 1978).

credit and limited social safety nets have liberal consumer bankruptcy systems. In order to diminish the prospects of widespread social unrest, these liberal consumer bankruptcy systems grant relief to large numbers of debtors. Generally, these persons are poor but honest debtors who seek relief based on loss of income or rising expenses, which are largely beyond their ability to control.

Chapter Three discusses individual debt restructuring in the United States, focusing on out-of-court resolution as well as cases under Chapters 7, 11, 12, and 13 of the United States Bankruptcy Code.² This chapter not only develops the substantive and procedural law involved, but summarizes the available data respecting restructuring costs, uniformity of remedy, and magnitude of indebtedness, assets, income, age, family status, and other attributes that profile individual debtors.

Chapter Four analyzes the goals and incentives that inform current restructuring laws in the United States. After discussing the traditional goal of equality of distribution of debtors' resources among creditors with similar legal rights, this chapter develops the concepts of discharge of indebtedness and fresh start.

Chapter Five explores deficiencies in the current restructuring regimes. Tremendous regional variations continue to exist in both out-of-court and in-court remedies. Some individuals are denied relief to which they are entitled because they are poor or uninformed. Others are denied relief because creditors or judges take unfair advantage of them. And others gain relief to which they are not entitled through abuse of the system. The insolvency system itself is exposed as inefficient and unjust. This chapter concludes by stating that reform is necessary and inevitable.

Chapter Six notes the structural impediments to reform that would be imposed in any situation generally and with respect to individual debt restructuring in particular. The dual state/federal system creates political obstacles to change. Path dependence limits the possibilities for change based on the enormous sunk cost in existing systems. And incumbency guarantees that radical reform will be opposed vigorously by creditors, lawyers, accountants, judges, court staff, and others who benefit from the current system. Irrespective of truth, some of these incumbents will make the "chicken little" argument that dramatic change to the current system is "dangerous" and will cause the sky to fall: "Banks will not lend money"; "Consumer credit will evaporate"; "The best consumer credit system in the world will collapse". Even academics who teach and theorize about individual debt restructuring will rise up to resist radical reform. This chapter concludes by anticipating the stock criticisms that accompany any reform proposal, including the need

²11 U.S.C. §§ 101-1330 (1994).

for further study, and the charges that existing data is flawed, that the proponent is acting out of self-interest or conflict of interest, and that the proposed reform will cost too much.

Chapter Seven sets forth the reform proposal. It begins by identifying the goals to be served and the conflicting values that underlie those goals. It next sets forth a proposal that attempts to reconcile competing interests in an inexpensive, just, and speedy manner. Chapter Seven concludes by explaining the proposal. The essence of Chapter Seven is what this Article entails.

I. CHAPTER SEVEN: THE REFORM PROPOSAL

A. UNDERLYING GOALS AND PRINCIPLES

In order to evaluate the proposal to restructure individual debts, we must first identify the goals and principles to be served by such a proposal. Several possible goals and principles come to mind:

- Individual debts should be restructured consensually, if possible;
- Individual debts should be restructured out of court, if possible;
- If intermediaries are required to assist with individual debt restructuring, a private system is preferable to a governmental system;
- Individual debt restructuring that involves more than one debt should treat creditors with similar legal rights similarly;
- Individual debt restructuring should afford the debtor a fresh start; i.e., the debtor should retain sufficient resources to survive and pursue employment without laboring under a debt burden that removes all incentives for the debtor to become productive;
- Individual debt restructuring should not be granted to a debtor with sufficient resources to pay all debts when due;
- Individual debt restructuring should be free from corruption;
- Individual debt restructuring should be inexpensive and incorporate a cost/benefit analysis;
- Individual debt restructuring should be expeditious;
- If individual debts cannot be restructured consensually, they should be restructured by operation of law, if the debtor qualifies;
- Confirmation of a debt restructuring plan should discharge the debtor from all dischargeable debts;

- An individual debtor should qualify for legally-imposed debt restructuring if:
 - (1) Voluntary debt restructuring has not worked;
 - (2) The debtor has no reasonable likelihood of paying debts as they become due;
 - (3) The debtor has not committed disqualifying bad acts;
 - (4) The debtor has not recently received the benefit of a compulsory debt restructuring; and
 - (5) The debtor has necessary contacts with the United States to invoke our laws;
- In order to obtain the benefits of individual debt restructuring imposed by operation of law, the individual debtor should be required to devote any surplus assets and a reasonable percentage of disposable future income to the repayment of creditors' claims;
- Uniform national guidelines should be enacted to define surplus assets and disposable income;
- Certain debts owed by an individual should not be subject to compulsory restructuring. These nondischargeable debts should include:
 - (1) All criminal obligations to whomever owed;
 - (2) Obligations arising from torts where the debtor intended to injure the person or property of another; and
 - (3) Alimony and support obligations;
- Individual debtors who seek compulsory restructuring should be counseled on how to avoid incurring excessive future debts;
- A compulsory restructuring system should be financed first from debtors' resources and second from the federal fisc;
- Government officials should supervise or audit persons who administer compulsory individual debt restructurings;
- The compulsory debt restructuring regime should be uniform in application throughout the United States;
- Debtors should be subject to involuntary relief with respect to the distribution of their surplus assets; and
- Debtors should not be subject to involuntary relief with respect to distribution of future income, but the debtor will be denied a discharge if he or she refuses to dedicate a reasonable percentage of any disposable income to repay creditors.

The current regime for restructuring individual debts adheres to some

but not all of these goals and principles. Variable application of compulsory individual debt restructuring under Chapters 7 and 13 of the Bankruptcy Code reflects strong underlying disagreement over some of these principles. For example, data show that individual debtors use Chapter 13 about half of the time in some districts, but only ten percent in other districts.³ While this discrepancy could be based on different regional attitudes on whether debtors want to devote their future income to repay their debts, a more plausible explanation is that judges and lawyers use their own values to steer individuals toward Chapter 7 or 13.⁴ The time has come to integrate individual debt restructuring in a unified chapter that will increase the prospects for uniformity.

The following proposal is premised on the goals and principles identified above, as well as the following contentions:

- There is a fundamental inequality of bargaining power between an individual debtor and creditor, favoring the creditor almost invariably;
- Individual debtors cannot afford to litigate to protect their legal rights in many circumstances;
- It is inefficient to use the federal court system to administer most individual debt restructurings;
- Some debtors will seek to obtain the benefits of individual debt restructuring without paying the price required by law to use the system;
- Although consensual individual debt restructuring is preferable to compulsory restructuring, the cost and delay to require an individual debtor to attempt consensual debt restructuring are unacceptable;
- The cost of monitoring the debtor's compliance in submitting future disposable income to the trustee for distribution to creditors requires the law to provide a threshold limitation in defining "disposable income";
- The Chapter 13 standing trustee system works well; and
- In order to effectuate a debtor's fresh start and induce the debtor to become a productive member of society, reaffirmation agreements should be unenforceable as a matter of law and public policy.

³Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801, 828-29 (1994).

⁴*Id.* at 839, 841-53.

B. PROPOSAL FOR THE RESTRUCTURING OF INDIVIDUAL DEBTS

1. CIDR in the Judicial Code

Prospectively, Chapters 7 and 13 will be consolidated into a single chapter of the Judicial Code⁵ to deal with compulsory individual debt restructuring ("CIDR"). Chapters 11 and 12 of the Bankruptcy Code will remain as available alternatives.

2. Eligibility

Any individual is eligible to be a debtor under the single chapter, if, at the time the CIDR petition is filed, the individual is not a stockbroker or commodity broker, has contacts with the United States as set forth in § 109(a) of the Bankruptcy Code,⁶ and has not received a discharge under Title 11 of the United States Code or in a CIDR within seven years prior to the date of the filing of the CIDR petition. (Perhaps sole proprietors should also be ineligible).

3. Commencement of CIDR

A petition for CIDR may be filed voluntarily or involuntarily (with standards similar to Bankruptcy Code § 303).⁷ Although there will be a filing fee payable to the Office of the United States Trustee, an impecunious debtor can proceed *in forma pauperis*.

4. Venue

The petition is authorized to be filed only with the Office of the United States Trustee in the district in which the individual principally resides.

5. Automatic Stay: Possession of Property

Upon the filing of the petition, a statutory automatic stay protects the debtor, the debtor's property, and codebtors, and the debtor retains possession of his or her property.

6. Standing Trustee

The United States Trustee will appoint and supervise a private standing trustee, similar to the standing Chapter 13 trustee under current law, who will administer the CIDR, including disbursements to creditors under the CIDR plan.

7. Standing Trustee's Fees

The standing trustee will be paid capped fees and costs as a percentage of disbursements, as under current law.

⁵28 U.S.C. §§ 1-3701 (1994 & Supp. II 1996).

⁶Section 109(a) provides that "only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title." 11 U.S.C. § 109(a).

⁷See *id.* § 303.

8. *Schedules*

The debtor will file sworn schedules with the United States Trustee and standing trustee. The schedules will identify assets and liabilities as well as income and expenses.

9. *Debt Counseling*

The standing trustee will meet with the debtor, counsel the debtor with respect to the causes of his or her financial difficulties, and discuss ways for the debtor to avoid future financial difficulties.

10. *Examination of the Debtor*

The standing trustee will review the schedules and examine the debtor with respect to their veracity.

11. *Audit of the Debtor*

At random (with a weighting toward asset cases), one in every 1000 debtors (or such other number as is cost-effective) will be subjected to an in-depth audit by the Office of the United States Trustee. The purpose of the audit is to verify the accuracy of the schedules to deter corruption. The audits will be financed out of filing fees, just as the current system is self-supporting.

12. *Standing Trustee's CIDR Plan*

After reviewing the schedules and examining the debtor, the standing trustee must promptly propose a CIDR plan to the debtor.

13. *Plan Provisions*

The CIDR plan is based on the premise that, as the price for the debtor's fresh start and discharge on confirmation, creditors are entitled to receive the net value, if any, of the debtor's surplus assets plus, if the debtor's annual income is at least \$50,000, seventy-five percent of four years' future disposable income, if any.

a. In particular, creditors would receive the net liquidation value of any surplus assets on hand as of the time of the filing of the petition, and if the debtor earns annual income of at least \$50,000 and agrees to receive a discharge, seventy-five percent of any disposable income earned within four years after the filing of the CIDR (with a floor of zero and a cap so that creditors cannot recover more than payment in full of their allowed claims, plus postpetition interest).

b. Unless the plan provides for redemption of surplus assets by the debtor from third-party funds, proceeds of nonsurplus assets that the debtor sells, or disposable income that is not required to be paid to the trustee under paragraph 13.a above, the CIDR plan must provide for the liquidation by the standing trustee of any surplus assets and the distri-

bution of proceeds, net of costs and liens, to creditors holding unsecured claims.

c. The determination of surplus assets and disposable income will be based on uniform national guidelines adopted by Congress and automatically indexed for inflation.

d. It will be permissible for debtors to convert surplus assets into non-surplus assets, even on the eve of filing.

14. *Treatment of Secured Claims*

The CIDR plan specifies the amount of any secured debts based on the liquidation value of the collateral, net of any costs of sale, determined as of the date of the CIDR petition. Secured claims are treated as under Chapter 13 of current law, except that a contract rate of interest (or if less, the maximum rate allowed by applicable law) is used on any deferred cash payments on the allowed secured claims.

15. *Bifurcation of Undersecured Claims*

As under current law, with the exception of mortgages secured only by the debtor's principal residence, undersecured claims are bifurcated into an allowed secured claim equal to the value of the collateral and an unsecured deficiency claim for the balance (unless the debt is nonrecourse).

16. *Specification of Nondischargeable Debts*

The CIDR plan must also specify any nondischargeable debts of the kind specified in paragraph 18 below.

17. *Debtor Files the CIDR Plan*

If the debtor agrees with the plan, the debtor signs it and files the plan with the United States Trustee. The standing trustee sends a one-page notice of the plan to all creditors indicating the identity of the debtor and the terms of the CIDR plan. If the debtor disagrees with the plan, the debtor can file its own plan with the United States Trustee and send a one-page notice to creditors indicating the identity of the debtor and the terms of the CIDR plan.

18. *Consensual Confirmation; Discharge*

If within thirty days after the mailing of notice, no creditor nor the standing trustee files an objection to confirmation with the bankruptcy court, the plan becomes effective, and an order confirming the plan is sent to the bankruptcy court for registration on a CIDR docket. No civil case file need be opened.

a. Generally, an order confirming the plan has the immediate effect of a discharge injunction and immediately discharges all unsecured civil debts, except those debts for alimony or support, whether or not designated under the plan, and intentional injury to the person or property of

another that are designated as nondischargeable under the plan. The only exception is that no discharge is given to a debtor in an involuntary case where the debtor's annual income is at least \$50,000, and the debtor refuses to consent to pay seventy-five percent of any disposable income as described in paragraph 13.a above.

b. Criminal obligations are automatically nondischargeable whether or not designated under the plan.

c. Creditors holding nondischargeable civil or criminal debts are stayed as long as the plan is operative.

19. *Contested Confirmation*

Creditors who believe that the debtor is ineligible, that the plan improperly fails to designate their debt as nondischargeable, or that the plan violates the financial fairness standard of paragraph 13 above, may file an objection to confirmation with the bankruptcy court within thirty days of the mailing of the notice of the confirmation hearing. The objection will be accompanied by a filing fee, and the bankruptcy court clerk will open a file for a civil adversary proceeding arising in the CIDR case. The bankruptcy judge will have jurisdiction over the CIDR adversary proceeding derivative from the district court.

20. *Contested Confirmation Hearing*

If an objection to confirmation is timely filed, the clerk of the bankruptcy court gives notice of a confirmation hearing at which the judge can enter an appropriate order.

a. If the debtor is ineligible, the judge must annul the automatic stay, dismiss the case and impose appropriate sanctions.

b. If the debtor is eligible, the judge must determine whether to confirm or modify the plan.

i. In making this determination, the judge will apply the financial fairness standard described in paragraph 13 above.

ii. The judge must modify the plan to require the liquidation or redemption of any surplus assets or to vary the amount of disposable income.

iii. The judge must also resolve any nondischargeability dispute and amend the plan accordingly.

iv. The judge must confirm the modified plan.

21. *Postconfirmation Matters*

Under a confirmed plan, the debtor must cooperate with the standing trustee regarding the sale or redemption of any surplus assets and delivery of any disposable income.

a. If the debtor defaults, the standing trustee must determine whether

changed circumstances warrant a modification of the plan. If they do, the standing trustee promptly proposes a modified plan to the debtor, and the process proceeds as in paragraphs 12 through 20 above, except that no income can be delivered to the standing trustee if it is earned more than four years after the date of filing of the original CIDR petition.

b. If the standing trustee believes that a modification is not justified, the debtor can propose a modified plan which will be noticed as set forth in paragraphs 17 through 20 above. If a timely objection to the modified plan is filed and the bankruptcy judge determines that the modification is not justified, then the judge must either: (i) impose an appropriate modification; or (ii) if no modification is appropriate, revoke or annul the confirmation order and discharge and dismiss the case.

22. *Valuation*

In order to discourage ongoing valuation disputes, the debtor will retain the benefit of any postpetition increase in the value of equity in retained or acquired nonsurplus assets, because unsecured creditors are only entitled to the net liquidation value of any retained surplus assets as of the date of the filing of the petition. If the plan requires seventy-five percent of disposable income to be paid to the trustee for distribution to creditors, however, creditors are entitled to seventy-five percent of any actual disposable income during the four-year period, including any disposable income generated as proceeds of asset sales.

23. *Reaffirmation Agreements Unenforceable*

Reaffirmation agreements are unenforceable, although nothing prevents a debtor from voluntarily repaying a discharged debt.

C. EXPLANATION OF THE PROPOSAL

Paragraph 1 of the above CIDR proposal consolidates consumer bankruptcy into one chapter. The chapter is placed in the Judicial Code in recognition of the primary role of the United States Trustee and standing trustee in administering the system. Unless there is a dispute with respect to the debtor's eligibility, the nondischargeability of a debt, or the confirmability of the plan, the clerk of court will enter an order confirming the plan without the involvement of a bankruptcy judge. The only time a bankruptcy judge will become involved is to hear one of the above-mentioned disputes or to rule on a contested plan modification. Removal of the bankruptcy judge from these cases should reduce costs and eliminate the need for duplicate sets of files.

Paragraph 2 of the proposal prescribes eligibility rules for the consolidated chapter. The proposal opts for bright-line qualifications to minimize

the prospects of litigation. Although it is theoretically desirable to require bankruptcy to be filed as a last resort, imposition of this test as an eligibility requirement probably would foster eligibility litigation that debtors could not afford to defend. Instead, this section eliminates stockbrokers and commodity brokers, because these debtors have customers who deserve special protections. It will be rare for an individual debtor to have customers directly; usually customers will do business with a partnership or a corporation, so the individual debtor-broker will not be disqualified. Paragraph 2 also requires contacts with the United States, as does § 109(a) of the current Bankruptcy Code.⁸ Finally, paragraph 2 creates a seven-year bar. The seven-year bar has biblical origins and is more onerous than the six-year bar of current law. A less restrictive alternative would not bar sequential filings, but would permit the bankruptcy judge to grant *in rem* relief from the automatic stay to prevent abuses.

It is possible that the consolidated chapter should also exclude individuals who are sole proprietors. To the extent that the debtor has debts that are not primarily consumer debts, it might be appropriate for the debtor to file a petition under Chapter 11 or 12 of the Bankruptcy Code, rather than under the consolidated chapter.

Paragraph 3 requires a petition initiating a CIDR case to be filed with the Office of the United States Trustee, rather than with the Bankruptcy Court.⁹ The petition may be voluntary or involuntary. A filing fee is payable to the Office of the United States Trustee to self-fund the system, although poor debtors can file *in forma pauperis*. Under paragraphs 19 and 20, disputes will be litigated before a bankruptcy judge, and a separate fee will be collected by the clerk of court when that litigation is initiated.

Paragraph 4 lays venue in the district in which the debtor principally resides. Since paragraph 13 requires the determination of surplus assets and disposable income to be based on uniform federal guidelines, venue shopping should not be an issue.

Paragraph 5 retains features of current law providing that the debtor remains in possession of his or her property. The automatic stay and codebtor stay will also apply as under §§ 362 and 1301 of current law.¹⁰

⁸See *supra* note 6 and accompanying text.

⁹The Supreme Court has recognized that "Congress might have delegated the responsibility [over bankruptcy cases] to an administrative agency." *United States v. Kras*, 409 U.S. 434, 447 (1973).

¹⁰Section 362(a) provides that the filing of a bankruptcy petition operates as a stay, applicable to all entities, of:

- (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

Paragraphs 6 through 12 develop a standing trustee system similar to that under Chapter 13 of current law. Under paragraph 6, the standing trustee is appointed and supervised by the United States Trustee. Paragraph 7 provides for payment of capped fees and costs out of plan distributions, as under current Chapter 13. Under paragraph 9, the trustee's function is to counsel the debtor to avoid future financial difficulties. This service is financed by the filing fee. Under paragraphs 6 and 12, the standing trustee is also charged with formulating a plan to be proposed to the debtor and serving as the disbursing agent under the plan. Furthermore, pursuant to paragraphs 8, 10 and 11, the standing trustee also examines the schedules and randomly audits debtors to root out corruption.

Paragraphs 13 through 20 concern the CIDR plan process. Under paragraph 17, the debtor either files the plan recommended by the standing trustee or files a plan of his or her own. Paragraph 13 specifies that the plan must give creditors payments over a four-year term equal to the liquidation value of any surplus assets plus, if the debtor's annual income is at least \$50,000, seventy-five percent of any disposable income. In a voluntary case, the filing of the petition constitutes the debtor's consent to pay seventy-five percent of any disposable income to creditors. In an involuntary case, the debtor with annual income of at least \$50,000 can elect whether to refuse a discharge and keep any disposable income or to receive a discharge and dedicate seventy-five percent of disposable income to repay creditors over four

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- (2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
 - (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
 - (4) any act to create, perfect, or enforce any lien against property of the estate;
 - (5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
 - (6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of a case under this title;
 - (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and
 - (8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

11 U.S.C. § 362(a). Section 1301 provides, in part:

a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless—

- (1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or
- (2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

Id. § 1301(a).

years. This election is used to minimize constitutional concerns.¹¹ The seventy-five percent level is used to give the debtor an incentive to generate disposable income. The \$50,000 threshold is selected to impose monitoring costs only in those cases where substantial disposable income is likely to exist. In many cases, there may be no surplus assets or disposable income. It is intended that disposable income can vary over the four-year period as the debtor's income and expenses vary. The thought is that when the debtor earns at least \$50,000, creditors should have access to any accumulated wealth as well as any excess future income. In order for the system to be efficient, the formulation of clear guidelines is essential. As noted, under paragraph 13 the determinations of which assets are surplus and how much income is disposable will be made based on uniform federal guidelines. These uniform guidelines will confront the difficult issue of whether the debtor is entitled to at most a minimum standard of living or whether the debtor may maintain his or her current standard of living unless it shocks the conscience. Under current Chapter 13, this issue is governed by § 1325(b), which requires the bankruptcy judge to reject confirmation of the debtor's plan unless the plan provides for full payment to unsecured creditors or provides that all of the debtor's projected disposable income to be received in the three-year period will be applied to make payments under the plan.¹²

¹¹See *infra* note 28 and accompanying text.

¹²Section 1325(b) provides as follows:

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—

(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

(2) For purposes of this subsection, "disposable income" means income which is received by the debtor and which is not reasonably necessary to be expended—

(A) for the maintenance or support of the debtor or a dependent of the debtor; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

11 U.S.C. § 1325(b). Thus, under current § 1325(b), the determination whether a debtor's plan provides that all of the debtor's projected disposable income will be used to fund the plan depends on the bankruptcy judge's determination whether the debtor's projected expenses are "reasonably necessary" for the maintenance or support of the debtor or the debtor's dependents. Absent uniform federal guidelines, this determination necessarily depends on the judge's individual value judgment and will vary from case to case and in cases before different judges.

For a comprehensive analysis of the benefits of uniform federal exemption levels, see generally Honorable William Houston Brown, *Political and Ethical Considerations of Exemption Limitations: The "Opt-Out" as Child of the First and Parent of the Second*, 71 AM. BANKR. L.J. 149 (1997).

Under paragraph 18, in most cases, all debts will be discharged on confirmation, except that the plan will not discharge criminal obligations, alimony or support obligations, or any designated debts for intentional torts where the debtor intended to injure the person or property of another. In addition, in order to reinforce the social benefits of the discharge, under paragraph 23 reaffirmation agreements are unenforceable. Unless an objection is filed, under paragraph 18, the order confirming the plan is automatically entered on the CIDR docket in the bankruptcy court. The bankruptcy judge is not involved in the process. On the other hand, if an objection to confirmation is timely filed, paragraphs 19 and 20 require the bankruptcy judge to resolve any disputes over the debtor's eligibility, the nondischargeability of debts, or the financial fairness standards.

Paragraph 21 requires the debtor to cooperate with the standing trustee in selling or redeeming any surplus assets or delivering any disposable income. For example, if the debtor owns a house and the equity in the house makes it a surplus asset, then the debtor must redeem the house or it will be sold by the standing trustee. The debtor might raise funds to redeem the surplus portion of the house by using proceeds of a gift, borrowed money, or net equity from the sale of nonsurplus assets. The debtor may also use any disposable income that is not required to be paid to the trustee. If the debtor defaults, by failing to sell or redeem surplus assets or deliver disposable income, either the standing trustee or the debtor can propose a plan modification. If the modification is justified, the court will confirm the modified plan. If modification of the plan is not justified, such as when the debtor's circumstances have not changed and the debtor has willfully defaulted under the plan, then the bankruptcy judge will revoke or annul the confirmation order and the discharge and dismiss the case.

Paragraph 22 clarifies that if the plan requires disposable income to be paid to the trustee for distribution to creditors, creditors are entitled to seventy-five percent of actual disposable income for the four years following the date of the petition, whether or not the amount of the income varies. One source of income can be the sale of nonsurplus assets. But in order to reduce valuation disputes, the debtor is given the upside in any nonsurplus assets or postpetition assets as long as they are not sold. Under paragraphs 14 and 15, with respect to any secured claims, this valuation is based on the liquidation value of the collateral, net of any costs of sale, determined as of the date of the filing of the CIDR petition.

Chapter Seven of the book would be followed by Chapter Eight, which would analyze the advantages and disadvantages of the proposal. It might look roughly like this:

II. CHAPTER EIGHT: ANALYSIS OF THE REFORM PROPOSAL

The CIDR proposal set forth above has several advantages over current law. The consolidation of individual debt restructuring proceedings will eliminate conversion and substantial abuse litigation costs. Although most litigation in individual consumer cases relates to motions for relief from the automatic stay or complaints to determine the dischargeability of a debt, some litigation involves motions to convert or dismiss and for substantial abuse.¹³

Removal of CIDR cases from the bankruptcy court system should also result in substantial savings. Instead of having parallel files maintained in the bankruptcy court clerk's office and in the Office of the United States Trustee, only the latter would retain most files. Moreover, the case burden on the bankruptcy court system would be reduced substantially. It is fair to ask why these cases belong in the bankruptcy court, except we have done it that way since 1898.

Consider the profile of the typical individual debt restructuring case. If past is prologue, of the one million-plus individual bankruptcy cases that will be filed in 1997, about seventy percent will be individual Chapter 7 cases and about thirty percent will be Chapter 13 cases.¹⁴ These cases will average about eighteen creditors that are owed approximately \$51,000 in debt, more than twice the average income of the debtors.¹⁵ The debtors will have above-average education and home ownership, but their median incomes will

¹³See, e.g., *Stuart v. Koch* (*In re Koch*), 109 F.3d 1285 (8th Cir. 1997) (motion to dismiss Chapter 7 case for substantial abuse); *Molitor v. Eidson* (*In re Molitor*), 76 F.3d 218 (8th Cir. 1996) (motion to convert Chapter 13 case to Chapter 7); *U.S. Trustee v. Joseph* (*In re Joseph*), 208 B.R. 55 (B.A.P. 9th Cir. 1997) (motion to dismiss Chapter 7 case for substantial abuse); *Beatty v. Traub* (*In re Beatty*), 162 B.R. 853 (B.A.P. 9th Cir. 1994) (motion to convert Chapter 13 case to Chapter 7); *In re Weber*, 208 B.R. 575 (Bankr. M.D. Fla. 1997) (motion to dismiss Chapter 7 case for substantial abuse); *In re Bicsak*, 207 B.R. 657 (Bankr. W.D. Mo. 1997) (motion to dismiss Chapter 7 case for substantial abuse); *In re Adams*, 206 B.R. 456 (Bankr. M.D. Tenn. 1997) (motion to dismiss Chapter 7 case for substantial abuse); *In re Eatman*, 182 B.R. 386 (Bankr. S.D.N.Y. 1995) (conversion of Chapter 13 case to Chapter 7).

¹⁴See Admin. Office of the U.S. Courts, U.S. Bankruptcy Courts Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code During the Twelve-Month Period Ended June 30, 1997 (1997) (on file with the Administrative Office of the United States Courts, Washington, D.C.); *U.S. Bankruptcy Courts Business and Non-Business Bankruptcy Cases Commenced, By Chapter of the Bankruptcy Code, During the Twelve-Month Period Ended June 30, 1996*, 29 Bankr. Ct. Dec. (LRP) No. 13, at 8 (Sept. 17, 1996); ADMIN. OFFICE OF THE U.S. COURTS, JUDICIAL BUSINESS OF THE UNITED STATES COURTS 268 tbl.F-2 (1995). See also Admin. Office of the U.S. Courts, *Bankruptcy Filings Continue Climb in 2nd Quarter 1997* (June 9, 1997) <<http://www.uscourts.gov/pressrel/bk33197.htm>> (showing that seventy percent of the individual bankruptcy petitions filed during the three-month period ended March 31, 1997 were Chapter 7 cases).

¹⁵Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook *Consumer Debtors Ten Years Later: A Financial Comparison of Consumer Bankrupts 1981-1991*, 68 AM. BANKR. L.J. 121, 128-29 tbl.1 (1994).

be about one-half of the norm for Americans.¹⁶ Seventy-five percent of the debtors will earn annual incomes less than \$27,000.¹⁷ Almost all of these debtors will have no reasonable prospect of repaying their debts.¹⁸ On average, although close to eighty percent of these debtors will be discharged overall (because only about one-third of Chapter 13 debtors receive a discharge while virtually all Chapter 7 debtors receive a discharge),¹⁹ in some districts over ninety percent of the debtors will be discharged, whereas in other districts fewer than half will be discharged.²⁰ Another twenty percent of the debtors will reaffirm some debts that would otherwise be discharged.²¹ In about ninety-six percent of the cases the debtors will have no nonexempt property.²² Yet over \$500 million will be charged in legal fees for these cases, and they will be administered as civil litigation in the federal court system by bankruptcy judges.²³ Each new bankruptcy judgeship costs the taxpayers an average of approximately \$600,000 per year, taking account of direct and indirect costs.²⁴ While most bankruptcy judges spend substantial time on Chapter 11 cases, significant energy is also spent on Chapter 7 and 13 cases, at least by law clerks and court clerks.

Based on the foregoing information, it is apparent that some savings can be realized by adopting the proposal, at least by stemming the increase in the number of bankruptcy judges and reducing the legal fees involved. Perhaps the savings will be substantial.

¹⁶*Id.* at 130.

¹⁷*Id.* at 128 tbl.1.

¹⁸*Id.* at 140.

¹⁹TERESA A. SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 215-17 (1989); Sullivan et al., *supra* note 15, at 143.

²⁰In the District of Rhode Island, for example, during the twelve-month period ended June 30, 1997 there were 4,673 individual Chapter 7 filings and 214 Chapter 13 filings out of 4,887 individual bankruptcy petitions. Assuming a one-third discharge rate for Chapter 13 cases, that means that approximately ninety-seven percent of the individual debtors received a discharge. In the Western District of Tennessee, on the other hand, during this same period there were 5,405 individual Chapter 7 filings and 18,129 Chapter 13 filings out of 23,546 individual bankruptcy petitions. These numbers translate into an approximate forty-six percent discharge rate.

²¹See SULLIVAN ET AL., *supra* note 19, at 319.

²²See Admin. Office of the U.S. Courts, Chapter 7 Asset and No-Asset Cases (1995) (on file with the Administrative Office of the United States Courts, Washington, D.C.).

²³See American Bankruptcy Institute, American Bankruptcy Institute National Report On Professional Compensation in Bankruptcy Cases 173-74 (1991) (reporting a mean average fee of \$761 charged for no-asset consumer Chapter 7 cases and a mean average fee of \$902 charged for routine consumer Chapter 13 cases). See also *Average Fees for Chapter 13 Cases*, 4 Consumer Bankr. News (LRP) No. 17, at 3 (May 25, 1995) (indicating an average of \$1,073 in fees charged in Chapter 13 cases).

²⁴Admin. Office of the U.S. Courts, Budgetary Information Compiled by the Administrative Office of the United States Courts (1997) (on file with the Administrative Office of the United States Courts, Washington, D.C.). According to the Administrative Office, the direct and indirect costs associated with each new bankruptcy judgeship total \$731,802 in the first year, and \$586,091 in each successive year. Thus, over a fourteen-year term, the average yearly cost of each judgeship is \$596,498.93.

The proposal also should operate to eliminate or severely reduce the disparate application of current bankruptcy law on the individual debtor. With one chapter and national guidelines, the disparity caused by local exemption planning and regional tastes should abate. To be sure, some judges can still interpret the law to find very few nonsurplus assets and to find that when the debtor's annual income is at least \$50,000, most of the debtor's income is disposable. But elimination of the substantial abuse standard of § 707(b) and the "reasonably necessary" standard of § 1325(b) takes away much judicial discretion in this area.²⁵

Finally, the proposal should provide meaningful relief to most debtors, giving them a fresh opportunity to become productive members of society. As noted, under current law, many Chapter 13 cases fail.²⁶ The debtor never receives a discharge, creditors receive payments from the standing trustee and, once the case is dismissed, debts accrue postpetition interest as though there never was a bankruptcy case. Even if the debtor gets a discharge, about twenty percent of the debtors enter into reaffirmation agreements.²⁷ Therefore, current law does not give many debtors the promised fresh start. The CIDR proposal grants a discharge on confirmation of the CIDR plan in almost every case. Moreover, reaffirmation agreements are unenforceable. As long as the debtor performs under the plan, the discharge is preserved. Many debtors will have neither surplus assets nor disposable income, so no performance will be required of them under the plan. Others will be able to seek modifications of the CIDR plan as their situation changes. Thus, the proposal should be better than current law in delivering a fresh start.

Some detractors of the proposal may point out that, based on the compensation formula, the standing trustee has a conflict of interest in designing the plan. Empirical data should be easy to gather to determine whether this fear is well-founded. If it is well-founded, the Office of the United States Trustee could remove the standing trustee. But I suspect that it is in the interest of the standing trustee to design a plan that will be performed so that the trustee can collect a percentage distribution for the full four-year term of the plan rather than dealing with the costs of a default.

Other detractors will focus on the fairness of the proposal to debtors and creditors. Some will contend the proposal is unfair to debtors because it is a "compulsory Chapter 13." There is no serious argument that such a proposal violates the Thirteenth Amendment.²⁸ Nobody forced the debtor to incur

²⁵See *supra* notes 12, 13 and accompanying text.

²⁶See *supra* note 19 and accompanying text.

²⁷See *supra* note 21 and accompanying text.

²⁸The Thirteenth Amendment provides that "[n]either slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction." U.S. CONST. amend. XIII, § 1. It is well recognized that

peonage—a condition in which a debtor is coerced by threat of legal sanction to work off a debt to a creditor—is a form of involuntary servitude prohibited by the Thirteenth Amendment. *United States v. Kozminski*, 487 U.S. 931, 943 (1988) (citing *Clyatt v. United States*, 197 U.S. 207, 215, 218 (1905)).

In the bankruptcy context, the Thirteenth Amendment has been raised as justification for the Bankruptcy Code's prohibition against involuntary petitions in Chapter 13 cases. Since, in Chapter 13 cases, the debtor's future income is used to fund the plan to pay creditors, Congress was concerned that an involuntary petition in Chapter 13 would constitute involuntary servitude under the Thirteenth Amendment:

As under current law, chapter 13 is completely voluntary. This Committee firmly rejected the idea of mandatory or involuntary chapter XIII in the 90th Congress. The thirteenth amendment prohibits involuntary servitude. Though it has never been tested in the wage earner context, it has been suggested that a mandatory chapter 13, by forcing an individual to work for creditors, would violate this prohibition.

H.R. REP. NO. 95-595, at 120-21 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6080-81. Although involuntary petitions are permissible under the CIDR proposal, this provision does not violate the Thirteenth Amendment because an unwilling debtor can refuse to pay disposable income to creditors by electing not to receive a discharge. As the Supreme Court has held, "[t]here is no constitutional right to obtain a discharge of one's debts in bankruptcy." *United States v. Kras*, 409 U.S. 434, 440 (1973). Thus, the debtor always retains the ability to refuse to work for his creditors and the debtor's participation in the CIDR process is always voluntary.

It has been suggested that a bankruptcy system that requires a debtor to work to repay his creditors as a condition on obtaining a discharge would be "strikingly close" to the condition of peonage, and thus violative of the Thirteenth Amendment. Karen Gross, *The Debtor As a Modern Day Peon: A Problem of Unconstitutional Conditions*, 65 NOTRE DAME L. REV. 165, 167 (1990). This assertion does not invalidate the CIDR proposal, however, because the debtor's service is not coerced within the meaning of the Thirteenth Amendment. In *Kozminski*, the Supreme Court stated that "our precedents clearly define a Thirteenth Amendment prohibition of involuntary servitude enforced by the use or threatened use of physical or legal coercion. The guarantee of freedom from involuntary servitude has never been interpreted specifically to prohibit compulsion of labor by other means, such as psychological coercion." 487 U.S. at 944. Conditioning a debtor's receipt of a discharge on the debtor's contribution of future income does not force the debtor to work through the use or threat of physical or legal coercion. A review of the Supreme Court jurisprudence on the subject demonstrates that, to constitute involuntary servitude, the consequences to the individual of refusing to work must involve the use or threat of physical force or legal imprisonment. See, e.g., *Kozminski*, 487 U.S. at 934 (physical force used to keep two mentally retarded men laboring on farm for no pay violated Thirteenth Amendment); *Pollack v. Williams*, 322 U.S. 4 (1944) (state law subjecting debtors to prosecution and criminal punishment for failing to perform labor after receiving an advance payment violated Thirteenth Amendment); *Bailey v. Alabama*, 219 U.S. 219 (1911) (same); *United States v. Reynolds*, 235 U.S. 133, 146 (1914) (criminal surety system whereby debtor contracted to work for a surety in exchange for surety's payment of debtor's fine, subject to criminal penalties should the debtor fail to fulfill the labor contract, violated Thirteenth Amendment). See also Gross, *supra*, at 184 ("It is not peonage when an individual chooses to work for his creditors, even if the choice is induced by somewhat disadvantageous consequences. To be peonage, the disadvantageous consequences must be dire. Specifically, the essence of peonage is an employment relationship that is enforced through a threat of imprisonment.") (citations omitted). Under the CIDR proposal, a debtor may simply refuse to work if the debtor wishes to do so. Although this choice will result in the loss of the debtor's discharge, no threat of physical violence or legal imprisonment exists to force the debtor to work against the debtor's will, and the Thirteenth Amendment is not violated. Cf. *In re Higginbotham*, 111 B.R. 955, 966-67 (Bankr. N.D. Okla. 1990) (holding that § 707(b) of the Bankruptcy Code does not violate the Thirteenth Amendment). It has been argued that the potential for imprisonment exists under state law for nonpayment of certain types of debts, and that this possibility creates the threat of imprisonment for insolvent debtors who do not work to obtain a discharge. Gross, *supra*, at 189-95. Under paragraph 18.b.

the debts, and nonbankruptcy law would allow garnishment of future wages well beyond the four years of the proposal. Although reasonable people can differ, it is fair and reasonable to require a debtor to agree to repay debts over a four year period out of seventy-five percent of any disposable income as a condition precedent to receiving a discharge. In the involuntary case, where the debtor's annual income is at least \$50,000, it seems fair to give the debtor a choice between agreeing to keep disposable income and forego the discharge or dedicating the repayment of seventy-five percent of disposable income as a quid pro quo for the discharge. On the other hand, if a constitutional problem develops, the proposal can be limited to voluntary relief.

Others will contend the proposal is unfair to debtors because it gives creditors access to both excess income and assets. Why should asset-rich debtors with little income be treated differently from asset-poor debtors with a substantial source of future income? Future income is simply an intangible form of asset. On the other hand, if all disposable income must be used to repay creditors, the debtor might not have an incentive to generate disposable income. To address this concern, the proposal requires distribution of seventy-five percent of any disposable income to the creditors and twenty-five percent to be retained by the debtor (which could then be used to redeem surplus assets or service secured or nondischargeable debt).

Some critics of the proposal will contend that the proposal is unfair to creditors because confirmation of a CIDR plan discharges too many categories of debt. While it is true that bankruptcy evolved from a creditor remedy to a remedy for poor but honest debtors, it is time for the system to evolve further. If the debtor has done something to harm society, the criminal justice system can address the problem, and the resulting obligation will be nondischargeable. The same is true for a civil debt that arises from intentional injury to the person or property of another. There is also a strong social policy protecting the sanctity of alimony and support obligations. But everything else should be discharged, because four years is a sufficient "sentence" to impose in exchange. This four-year rule will become the measure of the social contract. The four-year requirement should deter negative actions, but beyond a ratable share of seventy-five percent of four years' disposable income when the debtor's annual income is at least \$50,000, the creditors will have to buy insurance or self-insure.

Perhaps creditors will have an incentive to determine the creditworthiness of their debtor before extending credit. While this proposal might result in a contraction of consumer credit, that result might not be bad. If experience demonstrates that more than 1,000 debtors per year use the CIDR sys-

of the proposal, however, as under current Chapter 13, criminal obligations are nondischargeable and the threat of imprisonment is therefore unrelated to the debtor's decision to obtain a discharge.

tem to intentionally defraud creditors, it would be appropriate to amend the proposal to make nondischargeable those debts incurred with an actual intent to defraud creditors. The proposal rejects this as a starting point, however, because creditors could use the leverage of filing a nondischargeability suit to obtain a determination of nondischargeability even in the absence of fraud. It is no answer to award attorneys fees and costs to the prevailing debtor, since this approach has proved ineffective in a related context under § 523(d) of the Bankruptcy Code.²⁹

Critics who believe that the proposal is unfair to creditors might also argue that the unenforceability of reaffirmation agreements infringes upon the parties' freedom of contract. The short answer to this is "so what"? The typical consumer debtor is certainly not free; the inequality of bargaining power puts the consumer in a "take it or leave it" position. Many consumers are desperate for credit and do not make a rational choice to incur it (at outrageous interest rates in excess of eighteen percent per annum). If creditors are willing to extend credit on a volume basis without determining the creditworthiness of their borrower, it is hard to see why the law should encourage this inefficient activity.³⁰

Finally, some law-and-economics academics might contend that, as is true with respect to current bankruptcy law, the reform proposal is inefficient (and therefore unacceptable). Because the proposal provides for the discharge of indebtedness, it interferes with settled state law property rights and freedom of contract. It increases the cost of credit because bankruptcy losses will be passed on in the form of higher interest rates charged to all borrowers.

²⁹Section 523(d) of the Bankruptcy Code provides that the bankruptcy court shall award costs and a reasonable attorney's fee to a debtor who prevails in a nondischargeability case commenced by a creditor under § 523(a)(2), where the debt deemed dischargeable is a consumer debt and the court finds that the position of the creditor was not "substantially justified." 11 U.S.C. § 523(d) (1994). The purpose of this provision is to discourage creditors from bringing frivolous nondischargeability complaints with the hope of obtaining a settlement from an honest debtor who is anxious to avoid paying attorney's fees to defend the action. S. REP. NO. 95-989 at 80 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5866. In light of the high volume of frivolous nondischargeability complaints, however, "the desired effect of discouraging the creditor from bringing objections against the consumer debtor does not seem to have been achieved." RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 11.03 (1993). See, e.g., AT & T Universal Card Servs. Corp. v. Arroyo (*In re Arroyo*), 205 B.R. 984 (Bankr. S.D. Fla. 1997) (holding consumer debt to be dischargeable and awarding attorneys' fees under § 523(d)); AT & T Universal Card Servs. Corp. v. Duplante (*In re Duplante*), 204 B.R. 49 (Bankr. S.D. Cal. 1996) (same); AT & T Universal Card Servs. Corp. v. Stansel (*In re Stansel*), 203 B.R. 339 (Bankr. M.D. Fla. 1996) (same); AT & T Universal Card Servs. Corp. v. Chinchilla (*In re Chinchilla*), 202 B.R. 1010 (Bankr. S.D. Fla. 1996) (same); AT & T Universal Card Servs. Corp. v. Grayson (*In re Grayson*), 199 B.R. 397 (Bankr. W.D. Mo. 1996) (same).

³⁰Detailed development of this efficiency argument is beyond the scope of this Article. Suffice it to note that taxpayer-supported FDIC deposit insurance encourages banks to speculate in credit extension on a volume basis. If bank directors were personally liable for the bank's credit losses, a different result would obtain.

This will result in an underextension of credit that will prevent financing of marginally beneficial projects.

Some of these academics might also argue that the real purpose of the proposal is to redistribute wealth from creditors to debtors. Rather than using a cumbersome administrative apparatus to accomplish this result, it would be more efficient to achieve this policy through the tax system. The tax system could be amended to allow debtors a fresh start by permitting them to apply for a poverty tax credit (or transfer payment) that will give them enough income to make their creditors whole. Debtors could seek such a credit not more frequently than once every seven years and would be ineligible to receive a credit to pay nondischargeable debts.

Each of these academic attacks is suspect. On a prospective basis, bankruptcy law defines limitations on property rights *ex ante*. Although there may be a distribution of wealth, there is no redistribution. Moreover, an efficiency analysis presumes that more credit is good. Based on the lack of sophistication of most consumer debtors and their relative inequality of bargaining power, there may be valid regulatory or paternalistic goals served by a bankruptcy system. One example that serves these goals is set forth in paragraph 9 of the reform proposal: the standing trustee must administer debt counseling to the debtor. Finally, using the tax system to fund losses does not impose discipline on lenders to evaluate credit risks.³¹ Lenders who extend credit to debtors who default should bear the risk of loss, rather than imposing losses on taxpayers generally.

CONCLUSION

This essay has framed a reform proposal to restructure individual debts. Some commentators will embrace it; others will revile it. But the proposal should spark discussion on the fundamental objectives of a consumer debt restructuring system and the best way to achieve those objectives. Let the debate begin.

³¹See *supra* note 30.