A Case Study in Bankruptcy Abuse

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IX. Conclusion

The U.S. Supreme Court in the Rash case determined that a higher standard of value should apply when the debtor proposes to "cram down" the collateral in a Chapter 13 case. However, because of the practical effect of interpreting the meaning of "replacement value," little has changed in the valuation process. And, because the Chapter 13 system is stacked against the auto lender, and especially the sub-prime auto lender, valuation may be the least of the creditor's worries. However, despite the devastating effect of the automatic stay and the Chapter 13 cramdown, there are a few ways the pro-active creditor can and should protect its interests.

Because it is generally perceived by society that a Chapter 13 rehabilitation plan is preferable to a Chapter 7 liquidation from the standpoint of both debtors and creditors, Congress has taken steps to encourage Chapter 13 filings over Chapter 7. However, the societal preference for Chapter 13 is the worst thing that can happen to motor vehicle lien holders.

Commentary: A Case Study in Bankruptcy Abuse?

By Alvin C. Harrell

The articles in this Symposium on Bankruptcy Reform address issues and potential solutions relating to alleged credit and bankruptcy abuses. As a case study to conclude this Symposium, consider the following real-life bankruptcy case scenario.

The debtors obtained a first mortgage home loan on March 1, 1995, in the amount of $3,500 (yes, that is only $3,500), at a rate of 12% interest for three years. The home was old and in poor condition, with an estimated value of around $5,600. The loan payments were $115.10 per month. The loan was fully amortizing and would have been paid in full by now had the scheduled payments been made.

Just over a year after the loan was closed, the borrowers divorced. The wife was awarded the house. The husband had a good income and credit record, but soon filed bankruptcy, discharging his personal liability for the mortgage debt. Nonetheless, the wife (who continued to occupy the property) had a steady job and should have been able to pay the $115.10 per month house payments. She soon remarried and should have once again had a household with two incomes to make this minimal house payment. At the time of the divorce, the first mortgage loan balance had been reduced to just over $2,000.

Apparently the lawyer who handled the divorce continued afterward to advise the wife (now the sole debtor on the loan) regarding financial matters, as she made several prominent references to her lawyer in early conversations with the lender's staff. For whatever reason, immediately after the divorce the debtor ceased making payments on this $2,000 loan. At the time this article was written she had not made any further payment, except that on July 2, 1997 she made one payment (for September, 1996), apparently in an effort to delay commencement of foreclosure. In the roughly two-year period between late August 1996 and early July 1998, this was the only payment the lender received.

Despite the small size of the loan, and ample collateral, the lender worked hard to develop a forbearance arrangement with the borrower. Several workout arrangements were made and broken by the borrower, with the exception of the September, 1996 payment (paid in July, 1997). The borrower never made any of the promised payments. It finally became apparent that the debtor was merely stalling, and the lender reluctantly concluded that the debtor had no intention of paying the loan.

Finally, on August 22, 1997, a year after the debtor defaulted, the lender began foreclosure. By January 1998, a sheriff's sale had been conducted and the property had been sold (ironically at a price well above the lender's estimate of value) to an unrelated third-party bidder, who borrowed the funds elsewhere and paid the cash into the court. Then, only hours before the scheduled confirmation of the sale, the borrower filed bankruptcy under Chapter 13.

One of the losses in all of this was the buyer at the sheriff's sale, who paid interest on borrowed funds for several months during a frustrating effort to get his money back after the sale was canceled due to the Chapter 13 filing. While sheriff's sale bidders are not exactly a favored group, this sort of experience can only operate to impair the viability of foreclosure sales and further depress the prices received by borrowers and lenders. Ironically, the bidding at this sale was noteworthy for its generosity. But if bankruptcy is used to regularly foil sheriff's sales, frustrating the judicial process and imposing hardships on the bidders, we will soon be hearing more complaints by debtors' counsel that foreclosure bid prices are depressed because independent third parties seldom bid at sheriff's sales.

In the meantime the debtor had lived in the house for 16 payment-free months (through January, 1998). But now, it was thought, after the bankruptcy filing the debtor would at least have to make some payments under the Chapter 13 plan. The lender accepted the debtor's proposed plan, and waited to begin receiving payments. And waited. And waited.

When this article was written (early July, 1998) the lender still had not received a single payment under the Chapter 13 plan. [As this issue went to press, the lender received its first payment from the Chapter 13 trustee.] But the debtor has regular income, as she has had during the entire two-year period in question. And, once the plan was confirmed, she began making payments. Where did the money go between January and July, 1998?

What a surprise: Apparently it mostly went to pay the debtor's attorney, $1,400, along with some other smaller administrative expenses and priority claims.

Surely at this point the lender can be forgiven for feeling that this debtor, possibly in conjunction with her lawyer, intentionally abused the lender's good faith efforts to work with her, the state court legal system, and the bankruptcy process. From the lender's perspective, it appears that the goal of all this was to allow the debtor to retain the collateral for as long as possible without paying the lender, imposing the costs of collateral depreciation on the lender, and in the process divert any payments to the debtor's lawyer. When this article was written the lender had received only one payment in nearly two years, and after nearly six months had received nothing in the Chapter 13 case, while $1,400 was paid to the debtor's lawyer under the Chapter 13

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that yield spread premium payments can be valid payment for goods and services and that class certification is inappropriate.

Exactly how the Eleventh Circuit’s clarification of its holding in Culpepper will affect existing yield spread premium litigation will depend on how other courts react to this new opinion, and on the particulars of the individual cases. Lenders or other persons interested in the Culpepper decision, its subsequent clarification by the Eleventh Circuit, and other related issues should feel free to contact their counsel, or the authors, for more information.

The Science Behind Credit Card Offers

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past performance was the best indicator of future performance, but that paradigm is changing to a degree, as many products provide cash access utility. The availability of cash allows a greater degree of cannibalizing cash flow issues. In addition, a dramatic change in job security, health, or marital status can all negatively impact credit performance.

Rising consumer bankruptcy is the most critical issue we are facing, and controlling the flow of credit to consumers to limit out exposure is of utmost importance. Significant effort has been expended to train our employees to be excellent listeners and work with consumers at all times. Household activists support Consumer Credit Counseling which assists consumers through difficult financial times. On a personal level, I am a tremendous advocate of enhancing consumer credit education. Through my membership with the International Credit Association, I have been involved in teaching a high school curriculum and personally addressing over 1,000 teachers from Alaska to Florida and Delaware to California. Much work is required in this area, as I am convinced that heightened consumer awareness regarding the managing of financial affairs is critical.

I hope that my discussion has provided some insight into the sophistication and complexity involved as we attempt to manage consumer credit. My intent was to demystify a very complex process by discussing the many dimensions of making a credit offer and managing consumer credit. It is not our intent to overburden a consumer with debt, but provide a product that will offer value to the consumer and provide an adequate return to our shareholders.

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would have been paid in full long ago. She had a good equity in the house and should have owned it free of this mortgage by now.

Instead, after two years, the debtor’s loan balance (including foreclosure costs and the lender’s attorney fees) has doubled to roughly $40,000. The debtor’s equity in her home is probably gone (along with a sheriff’s sale bidder willing to pay a very generous price for the house). While anything is yet possible, it remains possible that this borrower will eventually lose her home to foreclosure. Even if this bankruptcy was used to relieve the debtor of other, more burdensome debts, it is not clear how the debtor benefitted by her two-year default on this home mortgage loan.

It is not clear why the debtor decided to default, stall, and file bankruptcy as an alternative to making the payments on her $2,000 first mortgage loan. We cannot know whether this debtor genuinely needed to default and file bankruptcy, or whether she was encouraged to take the easy road of default by the promise of bankruptcy relief.

If the prospect of bankruptcy encouraged the debtor to default on this $2,000 first mortgage loan, is any loan safe? Is it appropriate for bankruptcy to be used primarily as a means to delay a mortgage foreclosure (or enforcement of a security interest)?

Your author does not purport to know the answers to these questions, and is hesitant to sit in an ivory tower criticizing practitioners who are out there in the trenches trying to make the bankruptcy system work. But it is noteworthy that none of the

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6. The divorce decree indicates that the debtor had no other debts at the time of default, except income taxes and a small loan (both of which the former husband agreed to pay). This is consistent with the original credit application and credit report, which show no other debts except the above and a $600 credit card bill. However, your author has received other information indicating that there may have been significant other debts that justified the bankruptcy filing. But even so, what was the point of defaulting on his marital home mortgage loan?

7. This case is merely illustrative and is presented as such. However, other published reports suggest this may not be an isolated incident. See, e.g., Foreclosure Scare: What Can Be Done to Stop Them?, 32 BCD Weekly News & Commentary No. 18 (July 7, 1998) at A1.
of Commission member Edith Jones, which are included in the Report. She articulately advocates a significantly different approach to consumer bankruptcy reform.

[Ed note: Testimony of Judge Jones on these issues is included infra in this Symposium.]

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current bankruptcy proposals addresses the issues raised by this case. Shifting debates from Chapter 7 to Chapter 13 won’t help, a means-test for higher income borrowers is irrelevant here, and the proposals of the Bankruptcy Review Commission would drastically worsen the situation. Michael Donagan, in his article in this issue, describes some similar problems for secured creditors in the context of subprime auto lending, but otherwise these issues seem to be off the public-policy radar screen. Yes, the question of whether debtors in bankruptcy can pay more is an interesting one. But the continuing erosion of the rights of secured creditors may be the bigger news.

9. At least one Oklahoman bankruptcy judge is addressing the problem by requiring payment of the debtor’s attorney fees over the life of the plan, when unsecured creditors are to receive less than 20%. This should reduce the likelihood of plans being made to pay the attorney fees up front, at the expense of secured creditors, then dismissed.

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