

# Texas Law Review

## *See Also*

Response

### A Response to a Pretend Solution

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#### I. Introduction

When a noted academic such as Professor Katherine Porter undertakes an empirical study of consumer bankruptcy issues, it is important to pay attention both to the information gleaned and the conclusions drawn from the data.

In *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, Professor Porter draws radical conclusions about the failures of consumer bankruptcy cases based upon interviews of 303 debtors who, after filing a Chapter 13 petition, failed to reach discharge.<sup>1</sup> From her limited data, Professor Porter concludes that Chapter 13 is a glorious social failure because families that sought Chapter 13 relief did so with the expectation of achieving certain goals—principally related to home retention and respite from creditors—but did not realize their expected goals when their cases failed.<sup>2</sup> By noting that approximately two-thirds of the Chapter 13 cases fail to reach discharge, Professor Porter concludes that the Chapter 13 program should be scrapped because Chapter 13 is merely a “pretend solution.”<sup>3</sup> Upon closer examination, however, with due regard to the many options that

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1. Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 TEXAS L. REV. 103, 111–12 (2011).

2. *Id.* at 113.

3. *See id.* at 112 (recognizing that 14% of families had lost their homes and another 59% were in default within a few weeks of dismissal of their Chapter 13 cases); *id.* at 154 (arguing that “the time for pretending about the 1978 Bankruptcy Code has expired”).

exist for the benefit of Chapter 13 debtors to restructure or convert their cases, Professor Porter's conclusion that the system is broken lacks support.

## II. An Alternate Primer on Chapter 13 Bankruptcy Law

Professor Porter briefly outlines the legal structure of Chapter 13,<sup>4</sup> but some expanded review is merited.

The Chapter 13 program was borne out of an experiment in Birmingham, Alabama.<sup>5</sup> There, in the mid-1930s, Valentine Nesbit, a former Special Referee in Bankruptcy, developed a repayment option which became the model for Chapter XIII.<sup>6</sup> The original Chapter XIII, created as §§ 601–686 of the Bankruptcy Act,<sup>7</sup> was created to provide a method for an indebted wage earner to come into bankruptcy court for relief without being labeled “a bankrupt” and to get the benefit of a court injunction (automatic stay) to fend off creditors while the wage earner arranged to repay prebankruptcy debts in installments.<sup>8</sup> This method became codified in 1938 as part of the Chandler Act.<sup>9</sup>

Chapter 13 was created to be and has always been a voluntary alternative to the strict liquidation bankruptcy of Chapter 7.<sup>10</sup> In Chapter 7, debtors' nonexempt assets are liquidated by an independent trustee who then distributes the proceeds to general unsecured creditors in accordance with the priorities established by the Bankruptcy Code.<sup>11</sup> In a Chapter 13 case, however, the debtor has the ability to propose a plan that would repay creditors out of future income such that they receive at least what they would receive in a Chapter 7 case.<sup>12</sup> If no distribution would be made to unsecured creditors in a Chapter 7 case, a debtor's retention of assets would not compel any distribution to such creditors in a Chapter 13 plan. Accordingly, the creation of Chapter 13 was not seen as a means by which debtors could avoid

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4. *Id.* at 116–19.

5. See Harry H. Haden, *Chapter XIII Wage-Earner Plans—Forgotten Man Bankruptcy*, 55 KY. L.J. 564, 581–82 (1967) (explaining how one federal judge responded to the alarming rate of bankruptcy filings in Birmingham by carrying out a liberal interpretation of Section 74 of the Bankruptcy Act).

6. See *id.* at 582 (summarizing the role of Nesbit, who would “work[] out” plans between debtors and creditors and would ensure “prompt payments” through court proceedings).

7. Chandler Act of 1938, ch. 575, Pub. L. No. 75-696, 52 Stat. 840, 930–38.

8. See generally Haden, *supra* note 5, at 564–81 (discussing provisions of Chapter XIII of the Bankruptcy Act, including those related to the discharge of consumer debts).

9. See generally Chandler Act of 1938 § 623 (requiring a debtor who filed a petition under Chapter XIII to provide for payment of his debts out of his future earnings); *id.* § 625 (providing that a petition filed under Chapter XIII would “act as a stay of adjudication or of administration of the estate”).

10. Porter, *supra* note 1, at 105.

11. See *id.* at 116 (recognizing that Chapter 7 debtors receive an immediate discharge of unsecured debts for turning over nonexempt assets to their creditors).

12. *Id.* at 109, 116.

payment of debt, as is the general perception of Chapter 7. It was created as an optional, voluntary program, available to a debtor with regular income, to provide that debtor with the flexibility to avoid a Chapter 7 bankruptcy.

Chapter 13 has also provided a means whereby debtors can gain assistance in the repayment of debt. Many debtors are filing Chapter 13 cases, not with the intent of avoiding debts, but with the intent of using it as a mechanism to assist them in their repayment.<sup>13</sup> As such, Chapter 13 serves as an alternative, not only to a Chapter 7 case, but also as an alternative to a family overwhelmed by their own finances. The discharge for such debtors, though important, is not necessarily the motivating factor in their decisions to file.

A Chapter 13 plan is flexible, and the ability to modify and adjust the plan provides a mechanism by which debtors can deal with the changes that occur in their lives. Pursuant to § 1329, Chapter 13 plans may be modified upon motion of the debtor, an unsecured creditor, or the trustee.<sup>14</sup> Thus, Chapter 13 debtors who face changes in his personal financial conditions from the time they file are free to seek modification of the plan to conform it to the financial conditions that they find themselves in.

A Chapter 13 case is completely voluntary. No debtor may be forced into a Chapter 13 bankruptcy,<sup>15</sup> and any debtor who wishes to leave Chapter 13 is free to either convert the case to a Chapter 7 case or dismiss the case voluntarily.<sup>16</sup> Upon dismissal, debtors are placed in the same position as before filing: they have not received a discharge, and they have been protected during the term that they were in Chapter 13 bankruptcy by the automatic stay, but they are free to deal with creditors on their own outside of bankruptcy or to seek alternate relief.<sup>17</sup>

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13. One practitioner, in arguing for confirmation of a Chapter 13 case in Nashville, called the program “economic methadone”—a program to help wean his client off of easy credit with the supervision and assistance of a trustee.

14. 11 U.S.C. § 1329(a) (2006).

15. Although it is clear that Congress had the goal of limiting Chapter 7 relief to debtors who did not have the ability to repay debts, the remedy for dealing with an “abusive” Chapter 7 debtor, however, is dismissal. *See* Porter, *supra* note 1, at 116 n.63 (identifying the dismissal remedy for abusive Chapter 7 debtors); *see also* Katherine Porter & Deborah Thorne, *The Failure of Bankruptcy’s Fresh Start*, 92 CORNELL L. REV. 67, 118 (2006) (recounting congressional intent to limit access to Chapter 7 remedies given their generosity to debtors). While abusive Chapter 7 debtors may elect to convert to Chapter 13 bankruptcy, they cannot be compelled to do so. *See* Porter, *supra* note 1, at 116 n.63 (recognizing that only one-half of one percent of Chapter 7 debtors are forced into Chapter 13 proceedings, which occurs only after these debtors fail the means test and are unable to rebut the presumption of abuse).

16. Professor Porter notes that many involuntary dismissals of Chapter 13 cases may in fact be a voluntary decision of debtors to simply stop making payments. Porter, *supra* note 1, at 110.

17. Granted, a dismissed Chapter 13 case may have some transactional costs. *See, e.g., id.* at 105 n.14 (summarizing Chapter 13’s requirements for payments to creditors). Professor Porter has most likely overstated the actual costs of a dismissed case since most attorneys receive payments through disbursements in a plan. *See id.* at 118–19 (indicating that Chapter 13 allows debtors to pay attorneys’ fees under their repayment plans). Upon dismissal, all of the fees that were awarded are

Only the debtor can propose a Chapter 13 plan. Although the Bankruptcy Code imposes limits on what a Chapter 13 plan must contain and what a Chapter 13 plan may contain, it is the debtor who is responsible for determining how the plan is formulated, how it will operate, and which debts are paid.<sup>18</sup> It is the debtor who crafts the plan to which he or she must comply.

### III. Chapter 13 Is Complex; Chapter 13 Is Difficult

Professor Porter accurately recognizes that Chapter 13 is a complicated procedure which was created to provide to individuals the *option* of a repayment plan in lieu of Chapter 7 or nonbankruptcy workouts.<sup>19</sup> But the very nature of a legal option which is designed to restructure every secured claim, cure all defaults, and commit all projected disposable income, is, of necessity, complex.

It is not surprising, therefore, that a significant number of Chapter 13 cases are not completed. Professor Porter, comparing the discharge rates in Chapter 7 cases with the completion rates in Chapter 13 cases, attempts to compare two different programs, each of which has different requirements and each of which can create different outcomes.<sup>20</sup> After all, “successfully” navigating a Chapter 7 case to discharge essentially involves only the truthful disclosure of assets, liabilities, income, expenses, and prepetition transfers.<sup>21</sup> Whether a Chapter 7 case is successful often depends on what happens after the case is closed. Successfully navigating a Chapter 13 case to discharge involves all of the disclosures required in a Chapter 7 case, as well as the preparation of a comprehensive plan of repayment and—perhaps the most difficult requirement—the debtor’s compliance with the terms of the debtor’s own plan. Simply stated, proposing and living with a Chapter 13 plan is neither easy nor simple.

The rewards of Chapter 13, however, can be substantial. Even after the significant erosion of Chapter 13 by the Bankruptcy Abuse Prevention and Consumer Protection Act,<sup>22</sup> a Chapter 13 plan can lower payments on car

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not generally paid, particularly given the early dismissals in most cases. Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501, 550 (1993).

18. Samuel L. Bufford, *The Chapter 13 Alternative: A Legislative Solution to Undersecured Home Mortgages*, 45 U. RICH. L. REV. 1091, 1097–98 (2011).

19. *See supra* text accompanying note 10.

20. *See generally* Porter, *supra* note 1, at 154 (comparing the 95% discharge rate of Chapter 7 cases with the less than 50% success rate of Chapter 13 plans).

21. *See, e.g.*, Katherine Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 TEXAS L. REV. 121, 161 (2008) (noting that Chapter 7 debtors must accurately estimate mortgage debt and the amount of any outstanding arrearages). *See generally* 11 U.S.C. § 727(a) (2006) (outlining the grounds on which discharge is denied under Chapter 7, including destruction of relevant assets, fraud, inadequate explanation of asset losses and deficiencies, and refusal to cooperate with court proceedings).

22. Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

loans, reduce high interest rates on secured claims, cure defaults—particularly on mortgage obligations—and manage debts that are not subject to management or control after a Chapter 7 bankruptcy.<sup>23</sup>

#### IV. The Testing of Failures Only

Professor Porter tested the success of the Chapter 13 option, not by testing a random sampling of debtors who have successfully navigated a Chapter 13 case, or even a random sampling of debtors who filed a Chapter 13 case. Rather, her sample is drawn from debtors whose cases have failed.<sup>24</sup> Asking a random selection of debtors whose cases did not finish whether they accomplished the goals they had when they embarked on their bankruptcy journey is like asking a runner who could not finish a race whether he achieved the goal he had when he left the starting line. It is a rare runner who takes the starting gate without the goal of at least crossing the finish line.

Surprisingly, Professor Porter discovered that the overwhelming majority of her sampling pool of failed debtors felt that their decision to file Chapter 13 was a very good decision or a somewhat good decision.<sup>25</sup> It is altogether possible that the pool members recognized that the very nature of a Chapter 13 bankruptcy is in the nature of a quid pro quo—the benefits are available to those who can finish the plan that they create, and they do not expect to achieve those goals when they do not finish.

Because the burdens thrust on a family by Chapter 13 are self-imposed, we should perhaps be looking more at the scrutiny given Chapter 13 plans when they are approved by the court. A debtor's plan may retain collateral that is important or surrender property for which the debtor cannot pay.<sup>26</sup> Chapter 13 offers options to a debtor in creating a repayment plan. The fact is, however, that many Chapter 13 debtors propose plans which cannot be accomplished. The failure of a debtor's self-created plan is not a failure of the bankruptcy system; it is a failure of the debtor (and the debtor's counsel)

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23. For example, in a Chapter 13 case, a debtor with tax obligations—nondischargeable under Chapter 7—can pay those obligations through the plan, over its term without interest. See 11 U.S.C. § 1322(a)(2) (2006) (requiring Chapter 13 payment plans to “provide for the full payment . . . of all claims entitled to priority under section 507 of this title”); *id.* § 507(a)(8) (providing for priority of allowed unsecured claims of governmental units for certain taxes). Following Chapter 7 bankruptcy, the debtor is no longer protected and is subject to all of the collection tools available under applicable nonbankruptcy law.

24. See Porter, *supra* note 1, at 122 (identifying the sample as comprised of only Chapter 13 cases that have ended rather than all filed cases).

25. Professor Porter dismisses these debtors' postfailure attitude as not indicative of whether they had “accomplished their goals in bankruptcy or that their cases left them better off than they were before bankruptcy.” *Id.* at 141.

26. James J. Haller, *Creativity Alive in Chapter 13 Plans After Espinosa*, AM. BANKR. INST. J., Apr. 2011, at 40, 40.

to effectively and accurately evaluate the ability of that debtor to comply with his or her own plan.

There is nothing more optimistic than a debtor in a reorganization process seeking court approval of a plan. A number of behavioral studies have examined the tendency of individuals to disregard future risks. As one such study aptly observed in the bankruptcy context, “Individuals tend to be overly optimistic and overconfident regarding their own susceptibility to risk. Specifically, people systematically underestimate their own chances of suffering an adverse event, even if they understand perfectly well or even overstate the probability of others suffering the same fate.”<sup>27</sup>

Most Chapter 13 debtors whose cases fail—the data source for Professor Porter’s study—probably fit this overly optimistic and overconfident mold. Families seeking Chapter 13 relief are economically fragile, having suffered a financial setback from job loss, job reduction, or an expensive medical event. By proposing a Chapter 13 plan over a three- to five-year period, these plan proponents make the irrational and unsupported assumption that a debtor’s financial situation at the commencement of a case will remain consistent throughout the term of a Chapter 13 plan. These debtors discount, to a fault, their own susceptibility to financial setbacks during the performance of their own plan.

Ironically, Chapter 13 is designed to accommodate postpetition setbacks. A debtor may restructure a Chapter 13 plan to accommodate changes that occur during the case.<sup>28</sup> What Professor Porter’s study may show is that a high failure rate means that too many debtors do not avail themselves of the ability to modify their plans. The pretend solution is not a failure in the system—it is a failure of individuals to obtain the appropriate assistance to implement a flexible Chapter 13 plan.

Professor Porter’s examination of failed Chapter 13 cases mirrors her earlier study, where she found that one-third of the debtors who “succeeded” in their Chapter 7 cases still faced “an overall financial situation similar to, or worse than, when [those debtors] filed bankruptcy.”<sup>29</sup> Her earlier conclusion

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27. Jason J. Kilborn, *Behavioral Economics, Overindebtedness & Comparative Consumer Bankruptcy: Searching for Causes and Evaluating Solutions*, 22 EMORY BANKR. DEV. J. 13, 18 (2005) (footnote omitted).

28. See Henry E. Hildebrand III, *Toward a More Perfect Plan*, AM. BANKR. INST. J., Feb. 2003, at 10, 10 (observing that a Chapter 13 plan is binding as to “a number of issues”). Once a Chapter 13 plan has been confirmed, its terms are usually binding on the debtor and each creditor regardless of whether the creditor’s claim is provided for in the plan and whether the creditor has rejected or objected to the plan. 11 U.S.C. § 1327(a). Section 1329(a), however, allows the debtor to request a postconfirmation modification anytime prior to plan completion, subject to the same content and confirmation guidelines as an original plan in accordance with Section 1329(b). 11 U.S.C. § 1329. This section allows a Chapter 13 debtor to request an alteration of the amount payable to a particular class of claims, the time for payments on such claims, and the amount payable to particular creditors. *Id.*

29. Porter & Thorne, *supra* note 15, at 67.

is equally applicable to the problem she identifies in *The Pretend Solution*: postpetition “success” is keyed to a debtor’s ability to improve income.<sup>30</sup> Debtors who have the income stability or growth to experience the benefit of a Chapter 7 discharge may also be those debtors who could experience a successful Chapter 13 case because of an ability to comply with their own plans.

Debtors initially attempting to reorganize under Chapter 13 are free to convert their case to a Chapter 7 case. The two remedies are not mutually exclusive. Is it a failure for a family to initiate a Chapter 13 case in an effort to retain collateral, restructure loans, retain homes, or cure mortgage defaults but later convert to obtain the more limited benefits of a Chapter 7 discharge? Professor Porter responds in the affirmative.

#### V. The Promise of Chapter 13 Is Realized by Many

Professor Porter notes that the principal motivation behind the filing of a Chapter 13 petition is to “save the house.”<sup>31</sup> She notes that Chapter 13 (if successful) permits debtors to cure mortgage defaults, avoid foreclosure, and preserve the dream of home ownership. Is it a pretend solution if debtors (with adequate income) can propose—and accomplish—a plan which achieves that goal?

In many cases, that goal is accomplished. In Memphis, Tennessee, of 1,296 cases that achieved a discharge, 621 families successfully saved their homes.<sup>32</sup> Similar results were found in the Middle District of Tennessee where, during the same period, 1,021 families emerged from Chapter 13 with a discharge, having saved their homes from foreclosure.<sup>33</sup> Chapter 13 provided a remedy—successfully—to 621 families in Memphis and 1,021 families in Nashville. Surely for these families, the retention of their homes and the curing of defaults was not a pretend solution. The solution was very real and tangible. Chapter 13 is a consumer bankruptcy program that gives debtors a choice and a chance. It does not guarantee success any more than a

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30. *See id.* at 99 (“Families whose postbankruptcy income increases frequently experience an authentic fresh start. In contrast, the fresh start is likely to elude families whose incomes decrease, even after discharging debts. . . . Bankruptcy law does not attempt to prevent future income interruptions or to cushion families from a decline in income.”). A similar conclusion was reached in other studies. *See, e.g.,* Marianne B. Culhane & Michaela M. White, *Debt After Discharge: An Empirical Study of Reaffirmation*, 73 AM. BANKR. L.J. 709, 751–764 (1999) (arguing in favor of stronger screening mechanisms that would prevent debtors from committing to overly ambitious debt reaffirmations).

31. *See* Porter, *supra* note 1, at 136 (identifying Chapter 13 as “probably the most widespread home-saving device in American law”).

32. These statistics, maintained by George W. Stevenson, a Chapter 13 trustee in Memphis, are based on cases discharged from August 1, 2010, to August 31, 2011.

33. According to information maintained in trustee records, each of these cases was filed with a provision in the plan to cure a mortgage default, and each of these cases emerged from Chapter 13 with those defaults cured.

Chapter 7 case guarantees a financially secure future. Chapter 13 provides debtors with an alternative to a Chapter 7 case and an *opportunity* to restructure and reorganize.

By focusing only on debtors who fail to accomplish their Chapter 13 goals because they failed to complete their Chapter 13 plans, Professor Porter concludes that the system is broken. Contrary to her earlier study,<sup>34</sup> she assumes that Chapter 7's 95% discharge rate is a better outcome than that experienced by the approximately 50% of Chapter 13 debtors who did not "finish the race" or achieve their goals.<sup>35</sup> If we examine Professor Porter's work in her two studies together, we can easily see that she may be correct that bankruptcy—not simply Chapter 13—is a pretend solution for consumer debtors. While a bankruptcy can deal with existing debt, it cannot create income. That debtors exiting Chapter 7 cases with a discharge and those dropping out of Chapter 13 cases before discharge still experience problems after they leave may demonstrate a problem—but the problem may not be the bankruptcy system.

## VI. Conclusion

Professor Porter raises valid points when she challenges Chapter 13 because of its complexity and the unrealistic expectation of future financial stability of the participants. Such points apply equally to Chapter 7 debtors. Her suggestion, however, that because a successful (i.e., completed) Chapter 13 case is elusive for many, Chapter 13 provides but a pretend solution, is a step too far. Perhaps focusing on stricter scrutiny of a plan's feasibility at the case commencement or ensuring that legal assistance is available throughout the plan would help more people achieve their goals. Her goal of a single-chapter system, with its requisite limitations on choice and its empowerment of a benevolent bureaucracy substituting "rough justice" for the complexity of the existing system<sup>36</sup> may be a valid alternative. There may be a compelling case for scrapping our existing consumer bankruptcy system for one that is fairer, cheaper, or easier to navigate. The fact that a number of debtors in failed cases do not achieve the goals they originally had—without demonstrating that it was the system that caused the failure—does not make that case.

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34. Porter & Thorne, *supra* note 15, at 88.

35. Porter, *supra* note 1, at 153.

36. *Id.* at 154-55 & n.203.