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## Water for the Plants

### *How Reserve Funds Keep Chapter 13 Plans Alive on Rainy Days and Benefit Unsecured Creditors*

Unsecured creditors suffer when chapter 13 plans fail. Shockingly, failure is the ultimate result of a whopping 66 percent of all the chapter 13 cases filed nationwide, according to data from a 12-month period ending June 30, 2017.<sup>2</sup> Hockey legend Wayne Gretzky famously said, “You miss 100 percent of the shots you don’t take.”<sup>3</sup> The same is true in chapter 13 cases, where unsecured creditors miss out on 100 percent of the plan payments that debtors do not make. Therefore, logic yields that unsecured creditors are better off when debtors are making plan payments because it means they are getting paid, even if it is just pennies on the dollar, which add up over the course of 60 months.

Most of these failures are due to nonpayment of monthly plans. After a chapter 13 plan fails, debtors typically do one of two things: (1) refile a chapter 13 case; or (2) stay out of bankruptcy and allow the race to the courthouse to commence among creditors.

Refiling is very common. In 2016, 38 percent of all chapter 13 cases were filed by debtors who had filed at least one chapter 13 case within the previous eight years.<sup>4</sup> If a debtor does not refile, the cost of collecting on debts drastically increases (assuming any money is recovered at all). Absent bankruptcy, unsecured creditors are required to bring suit after default, get a judgment lien, have the sheriff levy the assets, then auction the assets. After all of this, the unsecured creditor receives whatever is left after auction fees are deducted — and these unsecured creditors are the lucky ones.

Because debtors are almost always insolvent, many unsecured creditors end up with no assets to levy. This tedious process causes many creditors to sell their claims to debt collectors, receiving only pennies on the dollar. While the same could be said about bankruptcy, completed chapter 13 cases result in predictability and usually at least some recovery.

Thus, it benefits unsecured creditors when chapter 13 plans succeed, since failures result in the debtor refiling, delaying recovery even longer. How can chapter 13 success rates be improved to benefit unsecured creditors? The Southern District of Texas has a solution, and the ABI Commission on Consumer Bankruptcy<sup>5</sup> believes it might be onto something.

The Southern District of Texas started creating reserve funds for chapter 13 debtors<sup>6</sup> to allow these debtors to pay for unforeseen costs that may arise throughout the life of the plan. These unexpected costs are almost an inevitability, and a singular (but significant) unforeseen cost can jeopardize an entire plan. What are the chances that a debtor, who is usually in a poor financial situation (causing the need to file for bankruptcy), does not incur a significant auto repair expense in five years? What are the chances that a debtor does not have to pay for a significant medical expense for herself or her dependents over five years?

An unpublished paper found that low-income families encounter roughly \$2,000 in unexpected expenses annually.<sup>7</sup> Thus, financial counseling services almost universally recommend “rainy day funds” for when these emergency expenses arise.<sup>8</sup> When budgeting, best-selling author Ramit Sethi recommends adding 15 percent of your estimated monthly expenses to account for unanticipated expenses.<sup>9</sup> Why is this advice completely ignored in bankruptcy?

Over the course of just six months, a 15 percent increase in monthly expenses could devastate a chapter 13 plan. For example, assume that a debtor’s monthly income is \$5,000 and the debtor’s reasonable monthly expenses are \$4,000, leaving \$1,000 of disposable income devoted to making plan payments. A 15 percent increase in the debtor’s reasonable monthly expenses would be an additional \$600, which would leave the debtor with only \$400 to make plan payments. Over six months, there-



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<sup>1</sup> The views expressed in this article do not reflect the opinions of Judges Thorne or Cassling, both of whom are ABI members.

<sup>2</sup> Hon. David R. Jones, “Savings: The Missing Element in Chapter 13 Bankruptcy Cases?,” 26 *ABI L. Rev.* 243, 253 (Summer 2018), available at [abi.org/member-resources/law-review](http://abi.org/member-resources/law-review) (unless otherwise specified, all links in this article were last visited on Dec. 23, 2019). The research provided by Chief Judge Jones proved to be immensely helpful to the authors of this article, and his work is cited repeatedly throughout.

<sup>3</sup> Paul B. Brown, “You Miss 100% of the Shots You Don’t Take.” You Need to Start Shooting at Your Goals,” *Forbes* (Jan. 12, 2014), available at [forbes.com/sites/actiontrumpseverything/2014/01/12/you-miss-100-of-the-shots-you-dont-take-so-start-shooting-at-your-goal](http://forbes.com/sites/actiontrumpseverything/2014/01/12/you-miss-100-of-the-shots-you-dont-take-so-start-shooting-at-your-goal).

<sup>4</sup> 2016 Report of Statistics Required by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, U.S. Courts, available at [uscourts.gov/statistics-reports/bapcpa-report-2016](http://uscourts.gov/statistics-reports/bapcpa-report-2016).

<sup>5</sup> See ABI Comm’n on Consumer Bankr., Final Report (2019), available at [ConsumerCommission.abi.org/commission-report](http://ConsumerCommission.abi.org/commission-report).

<sup>6</sup> Jones, *supra* n.2 at 246.

<sup>7</sup> Stephen Brobeck, “The Essential Role of Banks and Credit Unions in Facilitating Lower-Income Household Saving for Emergencies,” *Consumer Fed’n of Am.*, at 2 (2008), available at [consumerfed.org/wp-content/uploads/2010/08/Essential\\_Role\\_of\\_Banks\\_June\\_2008.pdf](http://consumerfed.org/wp-content/uploads/2010/08/Essential_Role_of_Banks_June_2008.pdf).

<sup>8</sup> See “Saving for an Emergency,” Wells Fargo Bank, available at [wellsfargo.com/financial-education/basic-finances/manage-money/cashflow-savings/emergencies](http://wellsfargo.com/financial-education/basic-finances/manage-money/cashflow-savings/emergencies); see also Dave Ramsay, “A Quick Guide to Your Emergency Fund,” available at [daveramsey.com/blog/quick-guide-to-your-emergency-fund](http://daveramsey.com/blog/quick-guide-to-your-emergency-fund).

<sup>9</sup> Ramit Sethi, *I Will Teach You to Be Rich*, Second Ed. 141 (Workman Publishing 2019).

fore, the debtor would fall into a \$3,600 default, an amount that would likely lead to dismissal of the case. Even a mere 5 percent increase in reasonable monthly expenses (\$200, assuming the same \$4,000 in expenses) would equal a \$1,200 default over six months — an amount also likely to lead to dismissal. If this hypothetical debtor had a \$4,000 reserve fund available, however, the debtor would not fall behind on payments, even with these unanticipated expenses.

Of course, the amount of unanticipated expenses will likely fluctuate month-to-month. There will likely be some months with minimal unexpected costs, and others with significant, unforeseen expenses. If debtors were able to exempt just 10 percent of their monthly income from their projected disposable income (\$500, using the aforementioned hypothetical), they would be in a much better position to withstand significant unexpected financial events without falling behind on plan payments.

Today, chapter 13 plans are typically structured such that the plan does not allow for any of these unforeseen costs.<sup>10</sup> All disposable income goes into the plan, without any consideration of unanticipated expenses.<sup>11</sup> Current practices are too cumbersome and inefficient for dealing with unexpected expenses. Currently, debtors must address emergency expenses through the modification of the chapter 13 plan and seek reduced or waived payments. However, these modifications cannot be granted quickly and cause the debtor to incur additional attorneys' fees. A simpler, quicker method is needed.

## How the Reserve Fund Works

Reserve funds provide flexibility to the hypothetical projections that the Bankruptcy Code implements to protect unsecured creditors in chapter 13 cases. Under § 1325(b), the entirety of a chapter 13 debtor's projected disposable income must be allocated toward plan payments.<sup>12</sup> Hon. **David R. Jones** of the U.S. Bankruptcy Court for the Southern District of Texas summarizes the Bankruptcy Code's definition eloquently in a 2018 law review article: "[Disposable income] is defined as a debtor's current monthly income, not including child support, foster care and disability payments, less reasonable living expenses."<sup>13</sup>

Typically, this is calculated by averaging the previous six months of the debtor's income. However, this definition places the debtor in a precarious position. Chief Judge Jones points out that a debtor can only succeed if "(i) the debtor's income is steady or rising; and (ii) the debtor encounters no significant unanticipated financial events during the plan term; or worse, the debtor creates a cushion by ignoring the oath attached to the official forms and inappropriately manipulates monthly expense numbers."<sup>14</sup> A reserve fund allows debtors without a rising income to afford unforeseen expenses without lying on their bankruptcy documents.

Under the Southern District of Texas's approach, the appropriateness of each reserve fund is determined on a

case-by-case basis,<sup>15</sup> and participation in this program is completely voluntary.<sup>16</sup> Upon completion of the plan, any money remaining in the reserve fund is returned to the debtor.<sup>17</sup> In order to withdraw funds to pay for an unexpected expense that arises during the life of the plan, the debtor is required to specify the amount requested and the reason for the withdrawal.<sup>18</sup> This can normally be done without an attorney's involvement through a simple form,<sup>19</sup> which ensures efficiency and limits attorneys' fees throughout the process. The judge's approval ensures that use of the funds is warranted.

Inspired by the Southern District of Texas's initiative, the ABI Consumer Commission formally recommended adoption of this practice nationwide.<sup>20</sup> There was disagreement among the Commissioners on whether this would require a statutory amendment to §§ 1322(b) and 1325(b)(2)-(3) or whether the current language allows for the creation of a reserve fund.<sup>21</sup> Either way, the Commission agreed (as do the authors of this article) that a statutory amendment would be the most effective method of implementing this practice.<sup>22</sup>

Under the ABI Consumer Commission's proposed statutory amendment, the fund would be limited to one month of the debtor's scheduled expenses, and the fund may be restored by additional debtor contributions to the extent of any disbursements from the fund.<sup>23</sup> The trustee will disburse the requested funds to the debtor 14 days after the debtor files notice, in the absence of objection from the trustee or an unsecured creditor.<sup>24</sup> While all excess funds in the Southern District of Texas are returned to the debtor, the ABI Consumer Commission distinguishes between debtors with incomes above the median specified in § 1325(b)(3) and those with incomes below the median.

For debtors with incomes above the median, the excess funds would be disbursed to unsecured creditors after the plan is completed.<sup>25</sup> Debtors with incomes below the median retain the funds at the completion of their plans.<sup>26</sup>

## How Do Reserve Funds Benefit Unsecured Creditors?

Unsecured creditors would benefit financially from an amendment of the Bankruptcy Code to allow chapter 13 debtors to maintain reserve funds during the life of their plans. The reason is straightforward: Unsecured creditors get paid more with plans that make it to completion than those that fail.

Reserve funds would allow unsecured creditors to get paid more because they allow debtors to continue making payments for longer. Data from Chief Judge Jones's article

<sup>15</sup> *Id.* at 246.

<sup>16</sup> *Id.* at 253.

<sup>17</sup> *Id.* at 255.

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> See ABI Consumer Commission Report, *supra* n.5.

<sup>21</sup> *Id.* at 174.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 171.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 172.

<sup>26</sup> *Id.*

<sup>10</sup> See 11 U.S.C. § 1325(b).

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Jones, *supra* n.2 at 251.

<sup>14</sup> *Id.* at 252.

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revealed that using the savings plan increases the average length of dismissed cases by two months.<sup>27</sup> This study also observed that “of all the cases in the data sample that utilized the savings provision, only seven requests for withdrawals were made — all in cases that remained pending as of the date of this study.”<sup>28</sup>

The results from the study provide evidence that unsecured creditors stand to benefit financially when the data is extrapolated and applied to a hypothetical situation. For example, assume “Bank” is an unsecured creditor in 100 different chapter 13 cases. Bank receives \$50 per month under the plans of each of the chapter 13 cases. This means that every two months, Bank receives \$100. Multiplied by

100 different chapter 13 cases, Bank would receive \$10,000 every two months in plan payments from its debtors. Therefore, by increasing the lives of these chapter 13 cases by two months, Bank would gain an additional \$10,000.

Therefore, reserve funds benefit unsecured creditors because empirical evidence suggests they lengthen the average lifespans of chapter 13 plans, which means that unsecured creditors receive more money in plan payments. Reserve funds also provide flexibility to the rigid projected-expense calculations that the Bankruptcy Code mandates, which puts debtors in a better position to withstand unexpected financial events, which are virtually certain to occur, without having their plans derailed. Although unsecured creditors do not seem like the obvious beneficiaries of the reserve funds discussed, some simple math and common sense reveal just how much they stand to gain. **abi**

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<sup>27</sup> Jones, *supra* n.2 at 266.

<sup>28</sup> *Id.*

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