

SELECTED CHAPTER 13 ADEQUATE PROTECTION ISSUES

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Adequate Protection: Generally

Prior to the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) in 2005, adequate protection was governed by section 361 of the Bankruptcy Code. That section provides:

11 U.S.C. §361. Adequate Protection

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by —

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity’s interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease or grant results in a decrease in the value of such entity’s interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.

11 U.S.C. §361.

Thus, periodic cash payments and replacement liens are the principal means by which debtors provide adequate protection for the diminution in the value of the creditor’s interest in property of the estate by virtue of the automatic stay or debtor’s use, sale or lease of such property.

Id. The list set forth in section 361 of the Bankruptcy Code was not intended to represent the exclusive means for providing adequate protection to creditors under the Bankruptcy Code. The

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amendments to 11 U.S.C. §1326 set forth in BAPCPA have created a new form of adequate protection as set forth in 11 U.S.C. §1326(a) (1)(C) which provides:

11 U.S.C. §1326. Payments

(a)(1) unless the Court orders otherwise, the debtor shall commence making not later than 30 days after the date of the filing of the Plan or the Order for Relief, whichever is earlier, in the amount –

(A) proposed by the Plan to the trustee;

.....

(C) that provides adequate protection directly to a creditor holding an allowed claim secured by personal property to the extent that the claim is attributable to the purchase of such property by the debtor for that portion of the obligation that becomes due after the order for relief, reducing the payments under subparagraph (A) by the amounts so paid and providing the trustee with evidence of such payment, including the amount and date of payment.

11 U.S.C. §1326(a)(1)(A), (C).

Implementation of Section 1326 Adequate Protection Payments

Although there is no useful legislative history accompanying the BAPCPA amendments to §1326, it is apparent that the changes were intended to prevent certain perceived abuses prejudicial to secured creditors. *See In re Brown*, 348 B.R. 583, 590 (Bankr. N.D.Ga. 2006). In particular, under pre-BAPCPA law, if the plan was not confirmed and the case was dismissed, payments made to the trustee would generally be returned to the debtor. Thus, a car lender, for example, would receive no payments for what could be several postpetition months preceding dismissal and therefore receive no adequate protection for the depreciation of the vehicle. To prevent that result, new

§1326(a)(1)(C) requires pre-confirmation adequate protection payments. Implementing the new requirement posed difficulties in many jurisdictions in which all pre-confirmation payments previously were paid to the trustee since §1326(a)(1)(C) requires payments directly to the creditor. As bluntly stated in Judge Lundin's treatise, "direct payments by the debtors before confirmation is a bad idea." 5 Keith Lunden, *Chapter 13 Bankruptcy* §401.1, at 401-1 (3d ed. 2000 & Supp. 2007-1). It interferes with the commencement of payments to the trustee, including the problem of starting an income deduction order in the proper amount. Direct payments are difficult to account for, and the procedure creates problems in claim allowance since the payments may reduce the amount owed on the petition date as set forth in the creditor's proof of claim. *Id.* at 401-1 to 401-2.

Fortunately, the direct pay requirement in §1326(a)(1)(C) can be superceded by the court since §1326 starts with the sentence "unless the court orders otherwise" (emphasis added). 11 U.S.C. §1326(a). Relying on this language in the statute, many courts have issued local rules, general orders or guidelines which alter or supplement the statutory scheme. For example, the Southern District of Florida issued an Administrative Order in 2005 (now adopted in its Local Rules, effective June 2, 2008) which requires debtors to make the §1326(a)(1)(C) adequate protection payments to the trustee as part of the plan payments, if the plan treats these creditors. In that district, as in many districts, all postpetition regular payments to secured creditors treated in a plan are paid through the trustee. Paying the required adequate protection to the trustee for creditors treated in the plan is consistent with that procedure. One benefit to this system is the ability for the trustee and creditors to monitor whether the debtor is current in his or her postpetition obligations without the need for a separate accounting from the creditors or debtor which would be necessary if the debtor made payments directly to the creditors. Other courts give the debtor the option to make adequate protection payments either directly to the creditor or to the Chapter 13 trustee. See e.g., the Chapter

13 plan form used in the N.D. Georgia, included in the Supplemental Materials for this program and discussed in *Brown*, 348 B.R. at 588. Copies of the local procedures for several other courts are also included in the Supplemental Materials.

Local procedures allowing or requiring debtors to make pre-confirmation adequate protection payments to the trustee have been challenged unsuccessfully in two reported decisions, the *Brown* case cited earlier, and *In re Beaver*, 337 B.R. 281 (Bankr. E.D.N.C. 2006). In *Beaver*, Bankruptcy Judge Small held that the direct pay requirement in §1326(a)(1)(C) does not provide the only method of providing adequate protection. The court alternatively found that the “unless otherwise ordered” language in §1326 gives the court discretion to alter the direct pay requirement in the statute. *Id.* at 284. In *Brown*, Bankruptcy Judge Bihary cited *Beaver* with approval and also concluded, over the creditor’s objection, that the debtor could make pre-confirmation adequate protection payments to the Chapter 13 trustee for disbursement to the secured creditor pending confirmation or dismissal of the case. *Brown*, 348 B.R. at 590.

Finally, Judge Lundin’s Chapter 13 treatise, cited earlier, enthusiastically endorses local procedures allowing adequate protection to be paid through the trustee.

That the bankruptcy court can order otherwise is an opportunity for enlightened courts, trustees and Chapter 13 practitioners to intercept the misguided direct payment process with a first-day order or local rule that makes pre-confirmation payments through the Chapter 13 trustee.

Lundin, *supra*, §401.1, at 401-2.

The bottom line is this: Chapter 13 practitioners must take heed of the new adequate protection requirements in §1326(a), but must also understand and comply with varying local procedures adopted to implement these statutory requirements.

Treatment of “910 Claims”

Language placed after §1325(a)(9) of the Bankruptcy Code has come to be known as the “hanging paragraph.” It provides:

“For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day (*sic*) preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor”

This new provision prevents the application of 11 U.S.C. §506 and bifurcation of a secured claim into secured and unsecured portions when (1) the creditor has a purchase money security interest, (2) in a motor vehicle acquired for the debtor’s personal use and (3) the debt secured by the vehicle was incurred within 910 days of the filing of the petition.

In several reported decisions, the issue is whether the lender holds a purchase money security interest (“PMSI”). *See e.g., In re Horn*, 338 B.R. 110, 113 (Bankr. M.D. Ala. 2006)(Williams, J.). The *Horn* court determined that there was not a PMSI where, prior to the bankruptcy filing, the debtor refinanced the loan on four occasions and received additional cash advances each time. The Court applied the “transformation rule,” *see Snap-on-Tools, Inc. v. Freeman*, 956 F.2d. 252 (11th Cir. 1992), and held that the creditor’s PMSI in the vehicle was destroyed because the debtor’s vehicle secured more than the debt for the money used to acquire it. *Horn*, 338 B.R. at 113-114. Therefore, the hanging paragraph did not apply; and the debtor could bifurcate the claim.

When debtors purchase vehicles, it is not uncommon for them to trade in prior vehicles which are worth less than the amount of the payoff on the trade-in. This has given rise to numerous cases considering whether the existence of this “negative equity” disqualifies these transactions from “910 claim” treatment. In *In re Pajot*, 371 B.R. 139 (Bankr. E.D.Va. 2007) (Tice, J.), Judge Tice issued an opinion consolidating several cases raising this issue. The court held that the presence of

“negative equity” in the trade-ins disqualified those transactions from “910 claim” treatment because the “negative equity” is not a component of the price of the collateral. Instead of applying the “transformation rule” to hold that the inclusion of non-purchase-money destroys the purchase-money character of the debt, the court applied the “dual status rule” and accorded “910 claim” treatment to the purchase-money portion of the debt.

The *Pajot* court followed what is considered the “majority view” set forth in several cases including *In re Peaslee*, 358 B.R. 545 (Bankr. W.D.N.Y. 2006). However, a month after the issuance of the *Pajot* decision, the *Peaslee* decision was reversed on appeal. *General Motor Acceptance Corp. v. Peaslee*, 373 B.R. 252 (W.D.N.Y. 2007). On appeal, the *Peaslee* District Court relied upon New York’s Motor Vehicle Retail Installment Sales Act to determine that the trade-in/purchase transaction should be viewed *in pari materia* and treated as one transaction for purposes of “910 claim” purposes. The district court therefore concluded that the “hanging paragraph” protected the creditors from having their claims bifurcated. Courts that have granted “910 claim” treatment despite the existence of “negative equity” have focused upon the definition a PMSI under state law.

Courts have also considered whether the inclusion of other charges in the contract preclude “910 claim” treatment. Whether a security interest is a PMSI is a matter of state law. *In re Townsend*, 2008 WL 920610 (Bank. D.Kan. 2008); *In re Macon*, 376 B.R. 778, 781 (Bankr. D.S.C. 2007). Applying South Carolina law, the *Macon* court determined that an extended warranty and “GAP” insurance coverage are properly part of the purchase money component of the debt because these additional charges have a sufficient nexus with the price of the vehicle and add value for the debtor. *Macon*, 376 B.R. at 781-82 (citing *In re Murray*, 352 B.R. 340, 349 (Bankr. M.D.Ga. 2006)(extended service contract, documentary fee, and government certificate of title fee did not

destroy PMSI). The *Macon* court considered and rejected contrary bankruptcy court holdings that insurance deficiency and extended warranty contracts “are not costs of acquiring the vehicle” and, therefore, not entitled to PMSI treatment. *Id.* (citing *In re White*, 352 B.R. 633, 639 (Bankr. E.D.La. 2006); *In re Price*, 363 B.R. 734, 741 (Bankr. E.D.N.C 2007)). The *Pajot* court split on these issues and ruled that extended warranty coverage is included as part of the PMSI while “GAP” insurance coverage is not. *Pajot*, 371 B.R. at 154-55. The *Townsend* court analyzed the definition of a PMSI under Missouri law and held that the cost of forced-placed insurance is included in a purchase-money claim. *In re Townsend*, 2008 WL 920610 (Bank. D.Kan. April 3, 2008).

Other cases have turned on whether the car was “acquired for the personal use of the debtor.” See e.g., *In re Press*, 2006 WL 2734335 (Bank. S.D.Fla. July 26, 2006)(Olson, J.). In *Press*, the court ruled that the “hanging paragraph” did not apply in a joint case to the debtors’ only vehicle which was purchased by a husband for his wife’s use. The court analyzed the meaning of “personal use” as follows:

The term “personal use” is nowhere defined in the Bankruptcy Code, although the term “personal, family, or household use” appears repeatedly throughout the Code. When Congress wants to include family or household use within the scope of the Bankruptcy Code, it knows how to do so, and indeed, did so in BAPCPA amendments to §506(a)(2). For example, § 101(8) provides that “[t]he term ‘consumer debt’ means debt incurred by an individual primarily for a personal, family, or household purpose,” 11 U.S.C. § 101(8). ... Consequently, the omission of “family or household” from the hanging paragraph means as a matter of statutory construction that the phrase “personal use” standing alone has a different meaning. *United States National Bank v. Independent Insurance Agents of America, Inc.*, 508 U.S. 439 (1993).

“Personal” is defined as “[o]f or relating to a particular person; private,” American Heritage Dictionary of the English Language (4th ed.2000) There is no implication in the plain meaning of the word “personal” in this context that includes the concepts of “family” or “household,” and there is nothing in the plain meaning of the statute that allows Drive to pull Barry Press under a penumbra cast by his wife,

Alicia Press, such that a car acquired for her “personal use” is transmuted into a car acquired for anyone other than her.

Id. In so holding, the *Press* court refused to consider the husband’s use of the vehicle stating:

Moreover, whether or not Barry Press may have made use of the car is irrelevant under the statute, which speaks only in terms of a car “*acquired* for the personal use of the debtor.” Drive points to nothing to challenge the Debtor’s assertion that the car was “acquired” for the personal use of Alicia Press. Under the plain meaning of the hanging paragraph, once the car was acquired for the personal use of Alicia Press, incidental or even frequent use by Barry Press is not a consideration under the plain meaning of the statute.

Id. (citing *In re Jackson*, 338 B.R. 923 (Bankr. M.D.Ga. 2006)(hanging paragraph inapplicable to vehicle titled in debtor but purchased for non-debtor spouse)). The *Press* court also rejected the creditor’s second argument pursuant to 11 U.S.C. § 102(7) that “the singular includes the plural” and that, therefore, “debtor” in the hanging paragraph is to be read as “debtors” in a joint case because the debtors’ bankruptcy estates had not been substantively consolidated.

The hanging paragraph has been held in a more recent case to not apply to a claim secured by a vehicle purchased by a debtor for her “now-estranged husband” with the debtor as a cosigner. *In re Pearson*, 2008 WL 687058 (Bankr. E.D.N.C. March 7, 2008)(Small, J.). The *Pearson* court ruled that “personal use of the debtor” meant “use for a non-business purpose by the debtor, not a family member of the debtor”. *Id.* (citing *In re O’Blenes*, Case No. 07-0284-5-ATS (Bankr. E.D.N.C. March 7, 2008)(Small, J.)(hanging paragraph inapplicable to vehicle purchased for use by debtor’s minor daughter)).

Surrender of “910 Vehicle” in Full Satisfaction of Debt

In response to the “hanging paragraph” creative debtors’ attorneys have included plan provisions providing for surrender of the “910 vehicle” in full satisfaction of the creditor’s claims. The first reported decision on this issue is *In re Ezell*, 338 B.R. 330 (Bankr.E.D.Tenn. 2006)(Stair, J.) in which the court ruled:

[i]f the property is to be *retained* pursuant to Revised 1325(a)(5)(B), the debtor must treat the entire claim as secured ... [and] must propose a plan that will pay the full amount of the claim as secured over the life of the plan. It only stands to reason that the same analysis is true when applied to surrender under Revised § 1325(a)(5)(C)—the creditor is fully secured, and *surrender* therefore satisfies the creditor’s allowed secured claim in full.

Id. at 340 (emphasis added).

In *In re Barrett*, 2007 WL 2081702 (Bankr. M.D.Ala. 2007) (Williams, J.) (direct appeal to the 11th Cir. pending), the court explained that its decision to confirm the plan proposing the surrender of the “910 vehicle” in full satisfaction is based upon the plain language of the statute stating:

The hanging paragraph creates a legal fiction that the vehicle is “worth the exact amount of the proof of claim.” *In re Durham*, 361 B.R. 206, 208 (Bankr. D.Utah 2006). Not every vehicle is worth the amount that is owed on the vehicle. This is especially true with newer vehicles that depreciate more rapidly on the front end.

If the debtor retains the collateral, this fiction operates in favor of the creditor by preventing bifurcation of the claim. If the debtor surrenders the collateral, this fiction operates in favor of the debtor by eliminating any deficiency claim. However inconsistent these results be with the value of the vehicle and economic realities outside of bankruptcy, they are consistent with the legal fiction created by the hanging paragraph that the vehicle is worth the amount of the debt.

The plain language of the statute treats the claims of qualifying creditors as fully secured whether the debtor retains or surrenders the collateral. Where statutory language is plain, “the sole function of the courts is to enforce it according to its terms.” *Ron Pair*, 489 U.S. at 241 (citations omitted). A creditor is “no more or less disadvantaged” by the hanging paragraph than the debtor. *Ezell*, 338 B.R. at 342. The provision operates against the creditor if the collateral is surrendered but

against the debtor if the collateral is retained. The result is “fair” and “in harmony with the language” of the hanging paragraph.

Id. Other cases permitting the surrender of “910 vehicles” in full satisfaction include *In re Moon*, 359 B.R. 329 (Bankr. N.D.Ala. 2007), (Caddell, J.); *In re Vanduyn*, 374 B.R. 896 (Bankr. M.D.Fla. 2007); *In re Williams*, 369 B.R. 680 (Bankr. M.D.Fla. 2007); *In re Pinti*, 363 B.R. 369 (Bankr. S.D.N.Y.2007).

While a majority of bankruptcy courts have permitted debtors to surrender “910 vehicles” in full satisfaction of “910 claims”, the only two circuit courts that have addressed the issue to date ruled in favor of the secured creditor and held that the hanging paragraph does not deprive a creditor of its state law rights to an unsecured deficiency claim. *In re Wright*, 492 F.3d, 829 (7th Cir. 2007); *In re Long*, 519 F.3d 288 (6th Cir. 2008). The *Wright* court held that section 506 “is not the *only* source of authority for a deficiency judgment when the collateral is insufficient” and based its holding in part on the inconsistency that would result if the debtors surrendered their vehicle the day before filing bankruptcy. *Wright*, 492 F.2d at 832. The *Long* court followed the *Wright* court’s rejection of surrender in full and held that the legislative gap in sections 1325(a) and 506 of the Bankruptcy Code under BAPCPA should be “filled and the Congressional mistake corrected” by applying the principle of “the equity of the statute” and looking to prior law. *Long*, 519 F.3d at 290, 297-98. In so holding the court stated:

4. *The hanging paragraph gap should be filled by prior law.*—The Supreme Court, addressing amendments to the Bankruptcy Code, has determined that “[w]hen Congress amends the bankruptcy laws, it does not write ‘on a clean slate,’ and, therefore, the “Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history.” *Dewsnup v. Timm*, 502 U.S. 410, 419, 112 S.Ct. 773, 116 L.Ed.2d 903(1992).

Because we are unable to find any legislative history that suggests that Congress intended to eliminate all deficiency claims upon surrender of the collateral and

because we conclude that a literal interpretation of the statute would create an unintended and illogical result, we decline to adopt a literal interpretation of the statute. Clearly, this is not an issue free from doubt, but where a statute cannot literally be applied without undermining Congressional intent, equity requires that this Court interpret the language to produce results that conform with Congress' intent and the overriding purposes of the Bankruptcy Code.

Id. In his concurrence, District Judge Cox concurred with the result but disagreed with the reasoning since he did not find a “gap” in the law to be “filled” by the courts. *Id.* at 299. Judge Cox noted that section 506 is not the source of the deficiency claim and would recognize the creditor's state law deficiency claim under section 502. *Id.* at 299-301. In dissent, Circuit Judge Clay thought the court had “overstep[ped] the bounds of judicial interpretation by essentially rewriting sections of the Bankruptcy Code” and would hold that the plain language of the Code precluded the deficiency. *Id.* at 301. Other cases holding that the creditor retains its right to a deficiency after the surrender of a “910 vehicle” include *In re Blanco*, 363 B.R. 896 (Bankr. N.D.Ill. 2007); *In re Clark*, 363 B.R. 492 (Bankr. N.D.Miss. 2007) (Houston, J.); *In re Hains*, 2007 WL 2570745 (Bankr. N.D.Ala. August 29, 2007)(Mitchell, J.); and *In re Rodriguez*, 2007 WL 2701295 (9th Cir. BAP August 28, 2007).

Insurance Proceeds as Cash Collateral

The situation often arises in Chapter 13 cases where the vehicle subject to a secured claim is totaled in an accident, and the debtor wishes to use the insurance proceeds to purchase a replacement vehicle. The issue becomes whether the insurance proceeds represent “cash collateral” pursuant to 11 U.S.C. §363 and whether the creditor's interest in the insurance proceeds can be adequately protected by a replacement lien on the replacement vehicle. Cases where the debtor was not permitted to use insurance proceeds to purchase a replacement vehicle include *In re Hardin*, 375

B.R. 506 (Bankr. E.D.Wis. 2007); *In re Van Stelle*, 354 B.R. 157 (Bankr. W.D.Mich. 2006); *In re Turnbull*, 350 B.R. 429 (Bankr. N.D.Ill. 2006); *In re Robinson*, 2003 WL 1728414 (Bankr. S.D.Ga. March 14, 2003); and *In re Suter*, 181 B.R. 116 (Bankr. N.D.Ala. 1994) (Cohen, J.). In these cases, the insurance proceeds were generally held to not constitute property of the estate; and the creditor could not be forced to make what is in effect a post-petition loan secured by the replacement vehicle.

Cases which have permitted debtor's use of insurance proceeds to purchase a replacement vehicle include *In re Witherspoon*, 281 B.R. 321 (Bankr. S.D.Ala. 2001) (Mahoney, C.J.); *In re Young*, 2000 WL 33673801 (Bankr. M.D.N.C. June 21, 2000); *In re Coker*, 216 B.R. 843 (Bankr. N.D.Ala. 1997) (Stilson, J.); *In re Feher*, 202 B.R. 966 (Bankr. S.D.Ill. 1996); *In re Ragin*, 1993 WL 13004569 (Bankr. S.D.Ga. Sept. 22, 1993); and *In re Woods*, 97 B.R. 850 (Bankr. W.D.Va. 1989). The courts in these cases held that the insurance proceeds were property of the estate which could be used by the debtor after providing the lender adequate protection in the form of a lien on the replacement vehicle and the monthly payments under the confirmed plan. These courts generally focused upon the debtor's need of a replacement vehicle in order to consummate the confirmed plan for the benefit of all creditors, not just the holder of the claim secured by the wrecked vehicle and the insurance proceeds.

One case of particular interest is *In re Sebastian* 2000 WL 33950137 (Bankr. C.D.Ill. January 13, 2000) in which the vehicle was totaled prior to the filing of the debtor's bankruptcy case. The debtor listed the vehicle as an asset and scheduled the creditor as the holder of a secured claim. The debtor filed a motion seeking bankruptcy court permission to use the insurance proceeds to purchase a replacement vehicle and granting a replacement lien on the vehicle to the secured creditor. The creditor objected contending that the debtors had no interest in the insurance proceeds since the creditor was named as the loss payee on the insurance policy. The creditor further contended that

the petition was not filed in good faith as its sole purpose was to force the creditor to finance a new vehicle for the debtor. The bankruptcy court sustained the creditor's objection and denied debtors' use of cash collateral to purchase a replacement vehicle.

At the other end of the spectrum is the *Young* case noted above. The *Young* court noted that this situation was typically worked out without court involvement in that district. The court held that the unexplained delay by the creditor in permitting the debtor to use the insurance proceeds to obtain a replacement vehicle constituted a willful violation of the automatic stay under the facts of that case. The *Young* court not only permitted the debtor to use the insurance proceeds to obtain a replacement vehicle but sanctioned the creditor by awarding actual damages and punitive damages in favor of the debtor and its attorneys.