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Keeping Your Collateral: Reaffirmation, Redemption and Post-petition Financing

This topic is going to be addressed by the panel in a three part discussion based upon the perspective of the three parties involved in the process and will include the three actions; reaffirmation, redemption and post-petition financing within those perspectives. The first part will be the perspective of the Debtor who wishes to retain the collateral which has been pledged to the secured creditor to secure the consumer loan. The second perspective will be that of the secured creditor who wishes to retain the benefit of the bargain for which he negotiated. The last perspective is that of the Judge who presides over the case and has the duties required of him or her in the process. Statutory citations will be provided in the debtor section, relevant case law in the creditor's section and judicial guidance in that section. While not a part of the discussion per se, it is important to keep in mind that under the Bankruptcy Code the Debtor has only three choices in regard to secured collateral, reaffirmation, redemption or surrender. Failure to do either of the first two options requires the last option.

DEBTOR'S PERSPECTIVE:

REAFFIRMATION

The issue of keeping your collateral through reaffirmation has, from the Debtor's perspective, again become a two- stage process since the 2005 amendments to the Bankruptcy Code. Assuming your clients are current on their secured loan at the time of the bankruptcy filing the initial decision belongs to them, do they want to keep the collateral and continue to pay for it? The statutory provision remains; 11 U.S.C. § 524(c), which provides generally for a written agreement entered after the filing of the bankruptcy case. The exact requirements go beyond section c and are contained in 11 U.S.C. § 524 (k). Bankruptcy Rule 1007(b) (2) and 11 U.S.C. § 521(2) requires the Statement of Intention to be filed and served upon the trustee and the creditors named in the statement. Under subsection A of that Code section the statement must be filed within 30 days of the bankruptcy filing or the Creditor's meeting whichever is earlier, unless the debtor requests and is granted additional time by the Court. Subsection B requires the intention to be performed by the debtor within 30 days of the Creditor's Meeting. The failure to perform the intention causes the automatic stay to terminate under 11 U.S.C. § 362(h)(1)(A)(B) but this does not apply to real property. The issues here are not really any different than prior to the 2005 Amendments and the place for creativity is in the negotiation of an agreement on behalf of the Debtor who is in default. The Debtor has no real statutory bargaining chip but must rely on the collateral for whatever leverage it may

provide. Used carpet, flooring and the like may not be items the creditor really wants back.

The second stage of reaffirmation is the step back into yesteryear and beyond with the requirement of the judicial hearing to approve the reaffirmation. Prior to the 1994 Amendments to the Code all Debtors were required to attend a hearing regarding reaffirmation and discharge. The 1994 Amendments, as embodied in Section 524 (c) (6)(A) and (d) made the hearing mandatory only for those Debtors not represented by an attorney. 11 U.S.C. § 524 continues the pro se hearing requirement but now adds subsection (m) (1) regarding the Court hearing on the presumption of undue hardship and the subsection (k) (5) certification by the attorney. The presumption section indicates that where the projected monthly income is less than the projected expenses there is a presumption of undue hardship on the Debtor. The attorney must certify whether the reaffirmation creates an undue hardship and this process triggers the hearing required by subsection (m)(1). The Court reviews the proposed reaffirmation agreement, the monthly income and expenses along with any statement of the Debtor in support of rebuttal of the presumption. From the Debtor's perspective it is the written statement in rebuttal which is contained in the reaffirmation statement itself that is the most critical element in the new process. First and foremost there should be no issue if the monthly income exceeds expenses in an amount sufficient to allow for the reaffirmation payment. Review your Schedules I and J and remember to delete the expense for the reaffirmation in question it was included on Schedule J. Also remember to delete expenses shown for ones previously disapproved, if any. Double-check Schedule I for projected changes expected in income. The rebuttal is the first line of defense in getting the reaffirmation approved as the Bankruptcy Clerk's office will look at it before sending it to Judge with their analysis. Your next line is with the Judge if you have provided a viable explanation you may eliminate the need for an actual hearing. If the Judge invites you to a hearing on the reaffirmation, preparation is the key. Be ready to have the Debtor testify in support of all available bases to rebut the presumption. Debtors need a place to live and a car to get to work; are the interest rates favorable, monthly payments small(both compared to marketplace conditions), how many remaining?

REDEMPTION

Redemption is the remedy provided by the bankruptcy law where reaffirmation or being forced to surrender the collateral both don't seem quite right. You have an item secured by a lien which is likely greatly in excess of the actual value of the item. The provision is contained within 11 U. S. C. § 722 which provides: " An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien in full at the time of the redemption." Bankruptcy Rule 6008 applies and requires a motion, on notice as the court may direct and is a contested matter under Bankruptcy Rule 9014. The secured creditor must be served in the same

manner as a summons and the case trustee is normally served with the motion also. From the Debtor's perspective this is like a right of first refusal on applicable property and exists as to the whole of the collateral not just the exempt portion so that you can redeem for the value and keep your collateral. The key issues are all spelled out in the statute and you can simply go down the list: 1) Individual debtor; 2) tangible personal property, 3) intended for personal use, 4) subject to lien securing dischargeable consumer debt, 5) exempt or abandoned, 6) pay holder full amount, 7) allowed secured claim.

While fitting within the requirements could be an issue, the practical and legal issues here are most often the valuation to be used, the amount of the secured claim and the amount in issue versus the costs to litigate. There is no better place to agree and settle because any protracted litigation will defeat any benefit to be gained by redemption. We are normally dealing with items of limited value and if the value is that small replacement in the marketplace should be an option. A positive of the 2005 amendments is that the valuation issue under redemption was given some clarification. 11 U.S.C. § 506(a)(2) now provides that in chapter 7 and 13 individual cases as to personal property it is "replacement value" as of the date of filing that controls. As to redemption specifically; "With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined." Redemption is a chapter 7 issue whereas in chapter 13 the claim is bifurcated into a secured and unsecured portion with replacement value as the guide. The issue of redeeming cars where way more was owed than the value has dropped off due to the amendment making replacement value rather than wholesale value the standard coupled with the bad economic climate and the inability to obtain 100% financing.

POST-PETITION FINANCING

The decrease of car refinancing for redemption is the perfect segue into the Debtor perspective on post-petition financing. Chapter 7 does not provide for Debtor post-petition financing as it is inconsistent with the concept of a liquidating Trustee. Only the Trustee has the power to use, sell or otherwise take advantage of the property of the estate under 11 U.S.C. § 363. Chapter 13 provides for self-employed debtors to have the 11 U.S.C. § 363(c) ordinary course use powers but that is not really post-petition financing. Chapter 13 uses for post-petition financing are two-fold. The major uses being new car purchases or leases in chapter 13 along with real estate refinancing, either for better payments or the pay of a chapter 13 plan in full. The statutory provisions are contained in 11 U.S.C. § 1303 which gives the Debtor exclusively the powers of a liquidating trustee under 11 U.S.C. § 363(b) and § 1305 which requires permission of the chapter 13 Trustee. Section 363(b) states; "The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate,..." That is a requirement of a Court hearing and order after some form of hearing. It provides an obligation on the Debtor to obtain. The interplay of §1305 is that the Debtor must obtain permission of the Chapter 13 Trustee for post-petition financing that is more minor or else the creditor cannot have a post-petition claim under § 1305(c). This is the

procedure most often used for new car loans and an example of non-practicable prior approval would be a breakdown on the road on a Saturday and a trade-in on a modest replacement. Section 1305(a)(2) provides a basis for post-petition financing for necessary consumer debts as allowed claims. It is always best to obtain prior Court approval and to have the debtor make wise choices in terms of the scope of their purchases or refinancing.

CREDITOR'S PERSPECTIVE:

CREDITOR REDEMPTION ISSUES

The starting point from the creditor's perspective in the Seventh Circuit is the case of Edwards. In re Edwards, 901 F.2d 1383 (7th Cir. 1990). It gives the debtor the three options in regard to personal property secured by a lien; reaffirmation, redemption or surrender. Redemption is governed by 11 U.S.C. §722 and has several key points. The first is that it only applies to “ tangible personal property intended primarily for personal, family or household use”. It means any personal property, including but not limited to vehicles, furniture, jewelry, appliances, all of which are subject to claim of exemption. Next limitation is that it cannot be property used to derive income, i.e., limousine or delivery truck since that use negates the family consumer use element.

How do you redeem? By paying the lienholder the amount of the lien secured by the collateral in a lump sum. Value is dealt with in 11 U.S.C. §506(a) the impact of which depends upon the comparison of the amount of the debt and the value of the item of personal property. If the creditor is oversecured the amount is the amount of the debt. If the creditor is undersecured then it is the replacement value of the collateral. Here 11 U.S.C. § 506(a)(2) defines the term for our purposes as: “the price a retail merchant would charge for property of that kind considering the age and condition at the time value is determined”. Stated another way, how much would it cost to buy the same thing from someone else? A key point is that it is the value at the time of the motion, not the filing of the petition unless the creditor can show bad faith in delay in bringing the motion to redeem.

Now that we know what the value is that we use, how is it determined? The most common methods are expert witness testimony or published value guides. Under Rule 803(17) of the Federal Rules of Evidence, “market quotations, tabulations, lists, directories or other published compilations, generally used and relied upon by the public or by persons in particular occupations” are admissible as exceptions to the hearsay rule. Important to note that appraisal are not an exception to that rule and you will need the live testimony to authenticate and introduce it into evidence. This evidentiary rule, and the following cases is how the NADA vehicle valuation guide is used as authoritative.(In re McElroy, 339 B.R. 185 (Bankr. C.D. Ill. 2006);(In re Smith,313 B.R. 785 (Bankr. N.D. Ind. 2004)).

Chapter 13 versus chapter 7 issues. For chapter 13 discussion see; Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997). That case discusses retail and replacement value in the chapter 13 context and the factors involved in that

determination. Where you have a redemption in a chapter 7 converted from chapter 13 redemption value is the chapter 13 claim balance. (In re Rodgers, 273 B.R. 186 (C.D. Ill. 2002)).

JUDICIAL PERSPECTIVE:

REDEMPTION

Section 506 requires replacement value in order to redeem. Most often the motions involve vehicles. The debtors must attach some support for the proposed value. Typically, a NADA or blue book value will suffice.

REAFFIRMATION

Reaffirmation is more problematic. In order for a reaffirmation agreement to be valid and enforceable, it must strictly comply with all of the requirements set forth in §524(c). The statutory reaffirmation scheme is to be strongly construed so as to protect the interest of debtors. The reaffirmation rules are intended to protect debtors from compromising their fresh start by making unwise agreements to pay dischargeable debts. Because reaffirmation agreements are effectively waivers of discharge with respect to a particular creditor, they are exceptions to the “fresh start” objective of the bankruptcy process and, as such, they are strictly construed and the requirements imposed for their validity are enforced rigidly. Accordingly, the Bankruptcy Code contains numerous safeguards to ensure that reaffirmations are genuine and that they are not entered into as a result of overreaching creditors’ practices.

All pro se debtors must be admonished of the consequences of reaffirming a debt. In addition, when a presumption of hardship arises and/or the attorney does not certify that the reaffirmation will not impose hardship, the Court must approve the reaffirmation after a hearing. The Clerk’s office reviews the reaffirmation agreement after it is filed. When a presumption arises, chambers is notified. In my chambers, the reaffirmation agreement and the supporting documentation is reviewed for two items. First, the schedules are reviewed to determine if the monthly payment was inadvertently left on Schedule J and resulted in an insufficient amount to pay the debt being reaffirmed. Second, the attorney certification is reviewed. Often times, an attorney certified that no hardship results, but the presumption is still noted. In those cases where the presumption is overcome based solely upon the agreement, I will enter an order approving without further hearing. In other cases, the matter is set for hearing. The debtor must appear and testify as to circumstances that overcome the presumption. Some attorneys notice the reaffirmation agreements for hearing. This usually occurs when the attorney feels he/she cannot certify that the reaffirmation agreement will not impose a hardship on the debtor. The debtor then appears in court and outlines the circumstances that overcome the presumption. Each Judge here in the Eastern Division has their own procedures. Judge Wedoff sets all agreements that give rise to the presumption for hearing. The debtor may

need to submit a revised budget or explain circumstances in order to overcome the presumption. He then explains the consequences of entering into a reaffirmation agreement at the hearing. Judge Sonderby sets some agreements for a hearing. Attorneys need to provide an adequate explanation in the supporting documents as to why the hardship is overcome, otherwise they and the debtor will need to appear in court. Judge Squires reviews the information and sets some matters for hearing. Judge Squires does not enter an order approving when it is not set for hearing.

Often, the debtors are reaffirming a mortgage. Such motions are generally approved in that saving a home is one of the main reasons to seek bankruptcy protection. In the aftermath of risky loans, however, it may be in the debtor's best interest to not reaffirm a mortgage that greatly exceeds the value of the home. Vehicles are also of some concern. Some vehicle loans carry an interest rate in excess of 20%. However, the ability to obtain more favorable loan terms is questionable.

Often, debtors seek to reopen a case to file a reaffirmation agreement. Judge Gorman recently issued an opinion holding that the Court cannot allow an untimely reaffirmation agreement. The following is an excerpt from *In re Golladay*, 2008 WL 2757077, (Bkrcty.C.D.Ill.2008):

The statutorily-prescribed manner by which a debtor, whose discharge date is approaching, should proceed in order to ensure that the debtor is able to enter into a valid reaffirmation agreement is set forth in Bankruptcy Rule 4004(c)(2), which provides in pertinent part as follows:

[O]n motion of the debtor, the court may defer the entry of an order granting a discharge for 30 days and, on motion within that, the court may defer entry of the order to a date certain. Fed.R.Bankr.P. 4004(c)(2).

The purpose of this Rule is to allow debtors "additional time to negotiate reaffirmation agreements given that they are not enforceable if entered into post-discharge." *In re Edwards*, 236 B.R. 124, 127 (Bankr.D.N.H.1999) (citing Fed.R.Bankr.P. 4004(c) Advisory Committee's Note).

The troubling practice of permitting the entry of discharge orders without moving for deferral under Rule 4004(c)(2) and then seeking to "set aside" or vacate those discharge orders to allow the filing of untimely reaffirmation agreements must end. This Court will continue to give full consideration to any motion seeking relief from a discharge order – or any order – pursuant to Bankruptcy Rules 9023 and 9024. However, as set forth above, Rule 9023 and 9024 motions are far from routine, and extraordinary circumstances must generally be plead and proved in order for such relief to be granted.

In order to be valid and binding, a reaffirmation agreement must be filed with the bankruptcy court. See 11 U.S.C. § 524(c)(3). However, § 524(c) does not require that

such an agreement be filed with the court prior to entry of the discharge in order to be valid. “[W]here it can be shown that the reaffirmation agreement was ‘made,’ *i.e.*, signed *before* the granting of the discharge, then the reaffirmation agreement may be ‘filed’ *after* the granting of the discharge.” *In re Davis*, 273 B.R. 152, 153 (Bankr.S.D.Ohio 2001) (emphasis in original) (citations omitted); *accord In re Whisenant*, 265 B.R. 164, 167 (Bankr.E.D.Ark.2001). Thus, it is not the filing of the agreement prior to the discharge date which is a necessary prerequisite for its validity; rather, it is the entering into the agreement, *i.e.* the full and complete execution of an agreement which satisfies the terms of the Bankruptcy Code and, particularly § 524(c), by all parties thereto which controls. *But see In re Pettet*, 271 B.R. 855, 856 (Bankr.S.D.Ind.2002) (reaffirmation agreement must be both made *and* filed prior to the entry of the discharge).