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REAFFIRMATION AGREEMENTS IN CONSUMER BANKRUPTCY CASES ¹

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INTRODUCTION

Consumer bankruptcy is intended to provide qualified debtors with a “fresh start” in their financial life.² To this end, the United States Bankruptcy Code (the “Code”)

¹ DANIEL A. AUSTIN & DONALD R. LASSMAN, REAFFIRMATION AGREEMENTS IN CONSUMER BANKRUPTCY CASES, AMERICAN BANKRUPTCY INSTITUTE (2009). This article is an overview of reaffirmation, with an excerpt from the book regarding the obligations of the debtor and debtor’s counsel; the book may be purchased from ABI at http://www.abiworld.org/source/orders/index.cfm?task=3&SKU=09_003.

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² *In re Vargas*, 257 B.R. 157, 166 (Bankr. D. N.J. 2001).

includes numerous provisions that modify the relationship between consumer debtors and creditors.

Most people finance the purchase of homes and vehicles through some form of purchase money security interest. Homes are typically financed through mortgages and vehicles by means of a lien shown on the state-issued title. Other types of personal property can also be subject to a purchase money security interest, but this is not common. If a borrower files for chapter 7 bankruptcy, home, vehicle, and other security interests are affected by the Code.

A chapter 7 debtor must file a number of documents, including schedules of income, expenses, assets, and liabilities. “Schedule D” of the chapter 7 petition is a list of all the debtor’s property that is subject to a security interest. In addition, the debtor must, within thirty days of filing the bankruptcy petition, file a “Statement of Intention”³ specifying whether the debtor intends to retain, reaffirm, redeem⁴ or surrender the collateral.⁵ If the debtor needs or wants to keep the property, such as a car for driving to and from work, the Code requires the debtor to either: (1) redeem the property, or (2) enter into a “reaffirmation agreement” with the creditor.⁶

A reaffirmation agreement is a postpetition agreement between an individual chapter 7 debtor and a creditor in which the debtor agrees to pay the prepetition debt and retain the property under the terms of the original security agreement between the debtor and creditor. By entering into a reaffirmation agreement, the debtor gives up the right to have the debt discharged through bankruptcy. One reason that debtors may feel compelled to enter into a reaffirmation agreement is because sections 362(h)(1)(A) and (B) of the Code provide that if the debtor fails to timely file the Statement of Intention and perform the stated intent, then the

³ 11 U.S.C. § 521(a)(2) (2009).

⁴ A debtor may redeem property pursuant to § 722 by paying the lienholder the present fair market value of the collateral.

⁵ “Surrender” means to return the collateral to the lienholder pursuant to 11 U.S.C. § 521(a)(2) (2009).

⁶ 11 U.S.C. § 521(a)(6) (2009).

automatic stay will terminate on the thirty-first day after the petition was filed.

Many consumer bankruptcy attorneys feel that a debtor need not sign a reaffirmation agreement in order to retain secured collateral, such as a residence or vehicle, because as long as the debtor remains current in his payments, the creditor is unlikely to repossess the collateral. Indeed, many states prohibit repossession of collateral for such a non-monetary, “ipso facto” default.⁷ The practice is known as “ride-through,” and is a common treatment for secured collateral in consumer bankruptcy.⁸

The prolonged economic downturn has raised a number of significant issues for consumer debtors in regards to “ride-through” and reaffirmation. For example, if a debtor in an underwater mortgage continues to make mortgage payments but does not reaffirm the loan agreement with the lender, what are the rights of the parties if the property later increases in value and/or the loan balance falls below the market value of the residence? Can a lender refuse to negotiate a loan modification agreement if the underlying debt has not been reaffirmed? Can the lender then foreclose on the property on the basis that the debtor failed to reaffirm? Or, what if the loan agreement has an adjustable rate mortgage (ARM) provision and the ARM later adjusts upward? If the debtor did not reaffirm the loan agreement, can the debtor refuse to pay the increased amount? Can the lender foreclose if the debtor refuses to make the higher ARM payment? These issues are certain to arise as housing prices recover, and the consequences for some debtors may be dire.

⁷ For example, Delaware, Idaho, Kansas, Massachusetts, Pennsylvania and West Virginia prohibit the enforcement of *ipso facto* bankruptcy clauses in consumer motor vehicle financing agreements. In several other states, such as Missouri, a lender may repossess a motor vehicle only if the borrower fails to make payment, or the lender shows that its prospect of payment on collateral is significantly impaired.

⁸ “Ride-Through” is discussed in Chapter III of REAFFIRMATION AGREEMENTS IN CONSUMER BANKRUPTCY CASES.

The following is from Chapter II of our book, REAFFIRMATION AGREEMENTS IN CONSUMER BANKRUPTCY CASES. This chapter sets forth the debtor's obligations in connection with reaffirmation of secured debt.

**I. THE DEBTOR'S PERSPECTIVE AND THE
ROLE OF DEBTOR'S COUNSEL IN THE
REAFFIRMATION PROCESS**

A. Introduction

Debtors are seldom aware of the options available to them to keep property that may be essential to their "fresh start."

For the majority of debtors, property such as jewelry, furniture, household goods, sports equipment, etc. are unsecured or otherwise exempt from creditors, so reaffirmation is not necessary. However, certain essential possessions such as automobiles and houses are typically covered by a security agreement, and it is for these types of possessions that the reaffirmation process is important. Debtors generally want to retain their homes and cars, the former because they need a place to live and do not want to disrupt the other members of their family, the latter because they are in need of basic transportation to and from work, shopping, and other needs. A critical element of planning for a successful consumer bankruptcy case is a thorough pre-filing discussion of the ramifications of surrender, reaffirmation, "ride-through" and redemption.⁹

⁹ Redemption is only available in chapter 7 proceedings pursuant to 11 U.S.C. § 722.

Reaffirmation not only allows a debtor to retain important personal property but may also be an opportunity to obtain more favorable loan terms. During the initial client interview, when discussing client goals, debtors will often indicate a strong preference to pay certain creditors or to keep some or all of their property. Moreover, because of the bankruptcy, it may be difficult or impossible for the debtor to obtain new financing for a motor vehicle and reaffirming their current vehicle may be the only way to keep the debtor in a car.

Counsel must also consider the effect that reaffirmation may have upon any nondebtor co-obligors who are liable with the debtor. Absent reaffirmation by the debtor, the creditor will undoubtedly seek payment from the co-obligors. If the bankruptcy filing by the debtor is an event of default under the terms of the loan, the creditor could accelerate the loan balance and seek immediate and full payment from the debtor's co-obligor. Accordingly, counsel must make sure that the debtor understands the impact that the decision whether or not to reaffirm may have upon a nondebtor co-obligor.

Debtors may be unrealistic in assessing their ability to make payments on a reaffirmed debt. Counsel should carefully explain the options available to the debtor, determine if the options are affordable and achievable, and make sure the debtor understands the ramifications of her selection. It is also important to remember that reaffirmation does not cure arrearages on secured debt, unless the creditor voluntarily agrees to accept payment on arrearages as part of the reaffirmation agreement. Nor can the reaffirmation process compel creditors to modify the terms of secured debt. Curing arrearages or modify debt terms is typically accomplished in chapter 13. Reaffirmation, which is unique to chapter 7, is not designed for debt restructuring.

B. Pre-filing Considerations

While a debtor may seek to reaffirm any debt listed on the bankruptcy schedules, as a practical matter, reaffirmation is usually only for debts owed to creditors that have a security interest in property that the debtor desires to retain. There is no reason for a debtor to reaffirm most unsecured obligations (such as credit card obligations, medical debt, etc.), unless the creditor provides some type of service that is critical to the health and/or wellbeing of the debtor.

1. Identify the Debtor's Assets

The first step in the reaffirmation process is to accurately identify all the debtor's real and personal property, and then to determine what property the debtor wants to keep and what property the debtor will surrender. Be careful to verify the type of ownership interest that the debtor has in the property, whether sole, joint or community.

2. Identify Liens

Once the nature and extent of the debtor's property interests have been determined, counsel must next work with the debtor to identify which debts are secured by liens on the debtor's property. In the case of real property, the best way to verify liens is to search the online records of the Registry of Deeds for the location in which the debtor's real property is located or commission a title rundown (frequently performed by title examination firms for under \$100). In either case, be certain to commence the search on the date that the debtor acquired its interest in the property. Accurately determining liens on personal property can be somewhat more problematic because many personal property liens are purchase money liens which, as a matter of state law, may not

be recorded. However, the type of personal property that debtors are overwhelmingly interested in retaining is motor vehicles, and lien verification can typically be obtained online or by contacting the Registry of Motor Vehicles. The existence of a lien on other types of personal property, such as furniture, computers and the like, may be more difficult to discover, and, in many cases, may depend on the law of the state in which the debtor resides. As a practical matter, experience suggests that creditors holding liens on personal property other than motor vehicles typically do not aggressively pursue reaffirmation or repossession.

3. Reviewing the Debtor's Ability to Pay

A key component of any reaffirmation agreement is the ability of the debtor to perform on the obligation being reaffirmed. Once the agreement is signed and, if necessary, approved by the court, the debtor must pay the debt according to the terms of the agreement. Accordingly, it is unwise to commit to an obligation that the debtor cannot reasonably be expected to be able to pay, since the debtor will be unable to seek relief from the obligation for at least eight more years.¹⁰ Preparation of the means test and schedules I and J is the optimal time to assess the debtor's ability to pay the reaffirmed debt. Counsel should also be mindful of the income information that must be submitted to the court for questions 1 and 2 on the Statement of Financial Affairs.¹¹ Does this information show that the debtor has sufficient

¹⁰ See 11 U.S.C. § 727(a)(8) (court may not grant discharge if debtor has been granted chapter 7 discharge in case commenced within eight years before filing current petition).

¹¹ Question 1 of the Statement of Financial Affairs requires the debtor to state the gross income that the debtor received from employment for the 2 years preceding the bankruptcy filing and for the year in which the bankruptcy case is filed. Similarly, question 2 of the Statement of Financial Affairs requires that debtor to list all income received other than from employment (i.e. interest income, alimony and child support payments, workman's compensation payments, etc.).

income to pay the debt that is to be reaffirmed, or will reaffirmation cause, or potentially worsen, a budget deficit? Most importantly, schedules I and J are tied directly into the reaffirmation process, and therefore those schedules should be prepared with a view toward supporting the debtor's proposed reaffirmed agreement(s). If it is apparent from a review of the debtor's finances that ability to pay will be an issue, then it may be necessary to explore alternative payment arrangements, such as contribution commitments from third parties or asking the creditor for more favorable terms. Contributions to a debtor by a third party might be helpful in convincing the court that the debtor will have sufficient resources to pay the reaffirmed debt.

4. The Statement of Intention

Section 521(a)(2) requires every individual debtor in a chapter 7 proceeding to file a Statement of Intention describing what the debtor intends to do with property that is subject to a secured claim. The Statement of Intention must be filed within 30 days of the date that the bankruptcy petition is filed, or on or before the date of the meeting of creditors, whichever is later,¹² and must be served on any creditor that has a lien on the property that is listed on the Statement of Intention. The debtor must select from the following options relative to the treatment of his property: (1) property will be surrendered; (2) property is claimed as exempt;¹³ (3) property will be redeemed; or (4) debt will be

¹² Presumably this means the date that the meeting of creditors is actually held, and not the first date set for the meeting of creditors, since these dates will vary if the first meeting has to be rescheduled.

¹³ The option of selecting "property claimed as exempt" on the Statement of Intent pertains solely to real property, since under § 521(a)(6), personal property cannot be retained unless the debtor enters into a reaffirmation agreement with the lien holder or redeems the property from the security interest of the lien holder. This option may be selected only if the property is subject to a lien that may be avoided under

reaffirmed. These are the only four options listed in § 521 and the only four options that appear on Official Form 8.

C. Post-filing Considerations

1. Performance of Stated Intent

Under § 521(a)(2)(B), the debtor has 30 days from the date first scheduled for the meeting of creditors to perform the stated intent. If the debt will be reaffirmed, § 524(c)(1) provides that the agreement must be made prior to granting the discharge. Typically, the secured creditor will transmit a partially completed form of reaffirmation agreement to the debtor and debtor's counsel. Counsel must be diligent to review the agreement to ensure that it conforms to Official Form 240B and includes the disclosures described in § 524(k)(3) and (4) through (8), all of which are incorporated into the Official Form. Some jurisdictions have added disclosures to those listed in § 524(k).¹⁴ Debtor's counsel must be aware of any locally required variations to the Official Form and be sure those variations are included in the agreement, since most attorneys for secured creditors adhere strictly to the Official Form. Moreover, failure to include all of the provisions set forth in § 524(k) may serve as grounds for denial of the reaffirmation agreement.

Debtor's counsel need not wait to receive a reaffirmation agreement from the secured creditor. While a debtor cannot complete Part A of the agreement, which is designed for

§ 522(f) on the grounds that the lien impairs the debtor's claim of exemption in the property.

¹⁴ In Massachusetts, the following language has been added to the attorney certification section of a reaffirmation agreement: "I do not warrant the ability of the debtor to perform the terms of this reaffirmation agreement, and the execution of this declaration by me shall in no way be construed as a guaranty by me of the debtor's obligations under this reaffirmation agreement." This language is intended to mitigate any adverse consequences to counsel that might arise as a result of signing Part C.

completion by the secured creditor, there is no reason why counsel cannot send a letter to the secured creditor requesting a reaffirmation agreement and include a copy of the form of reaffirmation agreement used in that jurisdiction. Being proactive can be important if the creditor is reluctant or unwilling to sign a reaffirmation agreement but the debtor wants to keep the collateral because it keeps the process moving forward so that applicable statutory deadlines for Reaffirmation Agreement filing and, if necessary, court approval, can be timely met.

A debtor cannot force the creditor to accept a reaffirmation agreement. However, if the debtor affirmatively seeks the creditor's execution of a reaffirmation agreement on the same terms and conditions as the original contract between the parties, the debtor has performed his stated intent and the remedy of automatic termination of the automatic stay applicable to nonperforming debtors is not available to the creditor.¹⁵ Although the agreement is not effective without the creditor's signature, the debtor's unilateral performance of his or her duties means that the creditor will have to seek the permission of the bankruptcy court before pursuing any default remedies, and some courts have refused to grant relief to the creditor under those circumstances. In essence, this forces the creditor to accept payment from the debtor, at least until the case is closed and the automatic stay terminates. Upon case closing, the creditor could then pursue its remedies in state court, but if the debtor has been timely paying throughout the duration of the bankruptcy proceeding, a state court may similarly refuse to grant relief of to the creditor, particularly where the only default is the debtor's filing of the bankruptcy case. (See the discussion on "ride-through" in Part III.).

¹⁵ See 11 U.S.C. § 362(h)(1)(B).

2. Consequences of Failure to Perform

Failure to timely file the Statement of Intention and/or perform the stated intent with respect to personal property within the statutory time periods can have grave consequences for the debtor. The automatic stay terminates and the secured creditor is permitted to pursue whatever remedies may be available under applicable non-bankruptcy law to recover the debtor's property. In fact, §521(a)(6) provides that the debtor *may not retain* possession of property unless the debt has been reaffirmed or the collateral redeemed, seemingly imposing an affirmative duty on the debtor to relinquish possession of the property and turn the property over to the secured creditor.

Most security agreements and promissory notes contain *ipso facto* bankruptcy clauses. Such clauses are invalid in some states, but for states that allow enforcement of *ipso facto* clauses, the bankruptcy filing itself would create a "non-monetary" default, which could serve as a basis for repossession and/or foreclosure of the security interest. As a practical matter, many secured creditors are content to allow the debtor to remain in possession of the property, even in the absence of an approved reaffirmation agreement, so long as the debtor remains current on the payments that are due. However, the debtor must understand that if he decides to not file a Statement of Intention and thereafter perform the stated intention, the secured creditor could declare a default at any time and seek to repossess its collateral. (See Part III, below.)

D. Undue Hardship and the Attorney Certification

Section 524(m) provides that a reaffirmation agreement is presumed to be an undue hardship if the debtor's expenses exceed income, which must be detailed on Part D of the

agreement.¹⁶ If there is a presumption of undue hardship, the court must review the debtor's circumstances." The presumption continues for 60 days after the date that the agreement is filed with the court. The presumption may be rebutted if the debtor includes with the agreement an explanation that "identifies additional sources of funds" that will be available to make the payments. The court may disapprove the agreement if the debtor fails to rebut the presumption to the satisfaction of the court.¹⁷

Bankruptcy Rule 4008 requires all debtors to include a statement of their income and expenses per schedules I and J with the Part D Statement of Income and Expenses. In most cases, the two will be exactly the same since it is unlikely that the debtor's income or expenses will have changed between the filing of the case and the execution of the agreement. However, should there be a discrepancy between schedules I and J and the Part D income and expense numbers, an explanation of the difference must be provided. For this reason, counsel must pay careful attention to the preparation of schedules I and J at the outset of a case. Moreover, both schedules I and J require debtors to describe "any increase or decrease in income or expense reasonably anticipated to occur within the year following the filing of the document." Thus, a debtor whose schedules I and J reflect expenses in excess of her income at the time that their bankruptcy case is filed may find it very difficult to obtain court approval of a reaffirmation agreement, absent intervention by a third party willing to supply the debtor with the funds necessary to meet the reaffirmation agreement payments. Further, any unexplained change in income or expense reported on Part D will likely trigger an inquiry into the veracity of schedules I and J.

¹⁶ Section 524(m) does not apply to credit unions. *See* 11 U.S.C. § 524(m)(2).

¹⁷ Section 524(m) does not expressly indicate what action by the bankruptcy court, if any, is necessary if the presumption is rebutted. The section states that the court shall review the presumption, but does not indicate what should happen if the presumption is rebutted. Presumably the court could then approve the agreement, but § 524(m) only refers to "disapproval" of the agreement if the presumption is not rebutted.

Counsel must also carefully consider the possible ramifications of signing Part C of the agreement, particularly in those cases where the debtor's monthly expenses exceed income. Counsel should consider not signing Part C if he or she does not reasonably believe that the debtor can make the payments on the reaffirmed debt. While an agreement can be approved without the attorney's signature on Part C, the probability that it will be approved is diminished. At least one court has found that the attorney's signature on Part C is a representation by the attorney that subjects the attorney to penalties if the debtor is subsequently unable to perform the agreement. Such penalties could include those listed in §526, malpractice claims, grievance actions by state bars and class actions by aggrieved former clients.¹⁸

E. Rescission

A debtor may rescind an agreement, but must do so prior to entry of the discharge order, or within 60 days after the agreement is filed with the court, whichever is later.¹⁹ The Debtor must provide notice of rescission to the holder of the claim. While the Bankruptcy Code is silent on the method of providing such notice, written notice is recommended so that the timing of the rescission notice is readily ascertainable. The rescission period provides the debtor with a period of time within which to test the assumption that necessarily underlies the agreement, namely that the debtor will have sufficient income to meet the payment that is being reaffirmed.

¹⁸ See *In re Mendoza*, 347 B.R. 34, 38–40 (Bankr. W.D. Tex. 2006).

¹⁹ See 11 U.S.C. § 524(c)(4).