

REAFFIRMATION AGREEMENTS

- 1.3.1 11 U.S.C. § 524(c) should be amended to provide that a reaffirmation agreement is permitted, with court approval, only if the amount of the debt that the debtor seeks to reaffirm does not exceed the allowed secured claim, the lien is not avoidable under the provisions of title 11, no attorney fees, costs, or expenses have been added to the principal amount of the debt to be reaffirmed, the motion for approval of the agreement is accompanied by underlying contractual documents and all related security agreements or liens, together with evidence of their perfection, the debtor has provided all information requested in the motion for approval of the agreement, and the agreement conforms with all other requirements of subsection (c).²⁹³**

Section 524(d) should be amended to delineate the circumstances under which a hearing is not required as a prerequisite to a court approving an agreement of the kind specified in section 524(c): a hearing will not be required when the debtor was represented by counsel in negotiations on the agreement and the debtor's attorney has signed the affidavit as provided in section 524(c), and a party in interest has not requested a judicial valuation of the collateral that is the subject of the agreement. If one or more of the foregoing requirements is not met, or in the court's discretion, the court shall conduct a hearing to determine whether an agreement that meets all of the requirements of subsection (c) should be approved. Court approval of an agreement signifies that the court has determined that the agreement is in the best interest of the debtor and the debtor's dependents and does not impose undue hardship on the debtor and the debtor's dependents in light of the debtor's income and expenses.²⁹⁴

The Commission recommends that the Advisory Committee on Bankruptcy Rules of the Judicial Conference prescribe a form motion for approval of reaffirmation agreements that contains information

²⁹³ Specific statutory language of this Recommendation is provided at the end of this chapter.

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enabling the court and the parties to determine the propriety of the agreement. Approval of the motion would not entail a separate order of the court.²⁹⁵

An individual debtor who receives a Chapter 7 discharge in bankruptcy is relieved of personal liability for prepetition claims for dischargeable debts. A debtor who seeks to cure secured debt defaults and repay prepetition debts files for Chapter 13. This cleavage is fundamental to the current structure of the consumer bankruptcy system. The Code presently provides one very significant exception that blurs the lines of this two pronged system: Chapter 7 debtors can become legally bound to pay dischargeable prepetition debts, while they discharge all others, if they “reaffirm” those debts by entering into agreements that satisfy certain baseline requirements.

Reaffirmations were almost banned by Congress in 1978. Instead, Congress opted to permit reaffirmations under very limited and closely monitored conditions. Once allowed, they grew to play an increasingly dominant role in the operation of the consumer bankruptcy system, but a role that, regardless of its dominance, is being called into question.

It is not surprising that reaffirmations have been at center stage throughout the Commission’s consumer bankruptcy hearings and debates. From the first days to the last, the Commission record is full of written and oral testimony on whether reaffirmation agreements undermine or facilitate the consumer bankruptcy system. Although views may differ on the benefit of reaffirmation agreements, most acknowledge that reaffirmations are largely creditor-driven. Creditors, debtors’ representatives, trustees, academics and judges reported to the Commission that many creditors request reaffirmation agreements as a routine part of their participation in bankruptcy cases.²⁹⁶ According to some creditors that have written and testified, such as individual credit unions, a reaffirmation agreement is a collection tool that permits them to continue doing business with debtors and is beneficial to the

²⁹⁵ Specific language of this Recommendation is attached at the end of this chapter.

²⁹⁶ *See, e.g.*, National Bankruptcy Review Commission Consumer Bankruptcy Working Group Session, February 20, 1997; National Bankruptcy Review Commission Plenary Session on Consumer Bankruptcy October 18, 1997. *See also* Letter from Bud Steven Tayman, Meyers Billingsley, Rodbell & Rosenbaum, Riverdale MD (May 8, 1996) (“information only” letters from creditors soliciting reaffirmations have become commonplace).

debtors;²⁹⁷ if debtors do not reaffirm their credit union debts, many credit unions have policies to eliminate nonreaffirming debtors from their membership.²⁹⁸

The prevalence of requests and agreements to reaffirm has provoked responses from within the system. Some judges now monitor case dockets and issue orders to show cause and hold hearings when the available information indicates that the reaffirmed debt exceeds the debtor's income or would impose an incredible financial burden.²⁹⁹ A number of districts across the country have adopted local rules imposing additional informational requirements about the reaffirmations being requested.³⁰⁰

In considering ways to improve the consumer bankruptcy system, some parties have questioned whether reaffirmations, which require payment to some creditors but

²⁹⁷ See Letter from Ron Haas, Chairman, Alabama Credit Union League (July 7, 1997); Letter from Derek Smith, Loan Department, First Community Credit Union, Ellisville, MO (August 8, 1997); Letter from Joe Irish, Collections Officer, Fergus County Federal Credit Union, Lewistown, Montana (July 16, 1997); Letter from Andrena MacLeod-Rock, Manager, United Credit Union, Council Bluffs, IA to National Bankruptcy Review Commission (May 6, 1997) (prohibiting reaffirmation not in consumer's best interest because reaffirmation shows good intention of repaying debt, which helps get future credit).

²⁹⁸ See Letter from Kenneth L. Robinson, President, National Assoc. of Federal Credit Unions, Washington, DC (April 16, 1997); Letter from Summit Federal Credit Union, Rochester, NY (April 2, 1997); Letter from Scott A. Guerin, Treasurer/Manager, Leominster Employees Federal Credit Union, Leominster, MA (April 29, 1997).

²⁹⁹ See *In re Hovestadt*, 193 B.R. 382 (Bankr. D. Mo. 1996); *In re Izzo*, 197 B.R. 11 (Bankr. D. R.I. 1996); *In re Reidenback*, 59 B.R. 248 (Bankr. N.D. Ohio 986).

³⁰⁰ See, e.g., Local Bankruptcy Rules for the United States Bankruptcy Court for the District of Montana, Rule 4008-1, Local Bankruptcy Forms, Forms 10, 10A; Local Rules of Bankruptcy Procedure for the District of Arizona 4008-1, Local Sample Forms 4008-1, 4008-2, 4008-3, 4008-4; Local Rules of the United States Bankruptcy Court for the Eastern District of Washington, Local Form 4008, Appendix A; Local Rules of the United States Bankruptcy Court for the District of Wyoming, Local Bankruptcy Forms, Application for Approval of Reaffirmation Agreement; Local Rules of the Bankruptcy Court for the District of Massachusetts, Standing Order on Requirements of Reaffirmation Agreement, Form 35; Rules of the United States Bankruptcy Court for the Eastern District of Oklahoma, Rule 11(B)(2); Local Rules of the United States District Court and Bankruptcy Court for the Southern District of West Virginia, Rule 8.05; Local Rules of the United States District Court for the Northern District of West Virginia, Local Rules of Bankruptcy Procedure, Rule 4.03; Maine Local Bankruptcy Rules, 4008-1; Set of Local Rules for the United States Bankruptcy Court for the District of Minnesota, Form 4008-1. See also Local Rules of the United States Bankruptcy Court for the Middle District of Louisiana Form 1 (Information required in attorney declaration); Local Court Rules of the United States Bankruptcy Court for the Western District of Texas, Rule 4008; Local Bankruptcy Rules of the United States Bankruptcy Court for the Northern District of Texas, Rule 4008; Local Bankruptcy Rules of the United States Bankruptcy Court for the Southern District of Texas, Rule 4008.

not others, are consistent with the policy of equality of distribution. According to others, reaffirming the debts that initially brought the debtor to the bankruptcy court undercuts the purpose of bankruptcy, as individuals go through the bankruptcy process only to emerge from Chapter 7 overloaded with debt. Creditor groups generally have advocated that Congress retain and possibly strengthen the ability of creditors to obtain reaffirmation agreements to make it easier to impose personal liability on debtors following the Chapter 7 discharge.³⁰¹ Academics who have studied reaffirmations from both empirical and policy standpoints advocate a variety of reforms; some support a complete ban on reaffirmations, while others believe that the system should allow arrangements to pay the value of collateral over time to secured creditors, while the unsecured portions of debts are discharged.³⁰²

The Commission's reaffirmation Recommendations are the product of a long period of deliberation and consideration of testimony. Originally, the Commission endorsed a Recommendation to prohibit all reaffirmations. Under this approach, any restructuring of secured debt through long-term payments generally would have been done in Chapter 13, increasing the Chapter 13 filing rates and assuring trustee supervision of pro rata distribution to all creditors. Further deliberation led the Commission to settle on a somewhat different approach that would permit reaffirmation of secured debt in Chapter 7 to the extent of the value of the property securing that debt, but would preclude reaffirmation of unsecured debts. The latter method would protect the interests of secured creditors in Chapter 7. Both approaches prevent unsecured creditors from seeking preferential repayments and increase the likelihood of financial rehabilitation.

History. The Bankruptcy Act of 1898 did not impose any restrictions on revived obligations of debtors to repay discharged debt. Left unregulated, debtors'

³⁰¹ See also Letter from Nicholas H. Penfield, Retail Bankruptcy Officer, Peoples Heritage Bank, Portland, ME (August 14, 1997); Letter from George J. Wallace, on behalf of the American Financial Services Association (February 21, 1997) to the National Bankruptcy Review Commission (recommending fine tuning to reaffirmation process, which generally works well); Memorandum from Charles L. Williams, III to Sarah B. Cummer, Federal Compliance Counsel, Credit Union National Association, Inc. (January 20, 1997) (reaffirmation process should proceed without judicial scrutiny); Letter from Steven D. Goldstein, President, Credit Department, Sears Roebuck & Co. (August 6, 1996) to National Bankruptcy Review Commission (Bankruptcy Code should provide clear statutory authorization that creditor can communicate with debtor to solicit reaffirmations, and that courts cannot interfere with voluntary reaffirmation agreements that otherwise comply with Code requirements).

³⁰² Letter from Marianne Culhane and Michaela White, Re: The VISA/Staten Consumer Debtor Study and Reaffirmation (June 11, 1997) (suggesting that superior approach would be to permit reaffirmations only to extent of value of collateral); Letter from Jean Braucher (July 8, 1997) (banning reaffirmation and permitting ridedthrough entails repayment on unsecured portion of debt, which is counter to bankruptcy policy); Lawrence Ponoroff, *Surf's Up, Dude: Riding Through Bankruptcy*, BANKR DEV. J. (Forthcoming 1997) (advocating ridedthrough).

discharges essentially were nullified in many instances by out-of-court agreements.³⁰³ Reportedly, coercive practices were implemented by some creditors to encourage debtors to waive their bankruptcy discharges.³⁰⁴ In its investigations of consumer finance practices, the Federal Trade Commission found that “an endless variety of techniques was employed to secure these agreements, usually prior to the consumer’s receipt of a discharge. The more common inducements were threats to property, threats to reputation and standing, and offers of additional cash.”³⁰⁵ Concerns about these practices underscored the 1973 Report of the Commission on the Bankruptcy Laws of the United States:

Substantial evidence of the use of reaffirmations to nullify discharges has come to the Commission’s attention. To the extent reaffirmations are enforceable, the “fresh start” goal of the discharge provisions is frustrated. Reaffirmations are often obtained by improper methods or result from the desire of the discharged debtor to obtain additional credit or to continue to own property securing a discharged debt. The Commission has recommended that the reaffirmation of a secured debt be enforceable but only to the extent of the fair market value of the property at the date of the petition. The Commission also recommends that a discharge extinguish all nonexcepted debts, reaffirmations be made unenforceable, and as under the present law, a judgment for a discharged debt be null and void.³⁰⁶

Early versions of the proposed Bankruptcy Code in both the House and Senate would have prohibited all reaffirmation agreements. The relevant provisions, which enjoyed bipartisan support, were designed to deal with concerns that “creditors have developed techniques that enable them to avoid the effects of a debtor’s bankruptcy, and bankrupts have suffered accordingly. Frequently they come through

³⁰³ H.R. REP. NO. 95-595 at 116, *reprinted in* COLLIER ON BANKRUPTCY, App. Pt. 2 (Lawrence P. King et al. eds. 15th ed. 1996).

³⁰⁴ *See In re Roth*, 43 B.R. 484 (N.D. Ill. 1984) (“Congress revised the Bankruptcy Code in 1978 to respond to serious abuses by creditors concerning reaffirmation agreements. Congress sought to protect unsophisticated debtors from wily creditors, who sometimes had pressured the debtors to sign reaffirmation agreements, a process which defeated the purpose of the ‘fresh start’ policies of the Bankruptcy Laws”), *citing* H.R. Rep. No. 595, 95th Cong. 1st Sess., at 163 (1977).

³⁰⁵ Statement of David H. Williams, Attorney, Division of Special Projects, Bureau of Consumer Protection, Federal Trade Commission, Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94 Cong. 1st & 2d Sess. at 758-63 (1975-76) (endorsing invalidation of reaffirmations).

³⁰⁶ REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 93-197, 93d Cong., 1st Sess. at 177 (1973).

bankruptcy little better off than they were before . . . The unequal bargaining position of debtors and creditors, and the creditors' superior experience in bankruptcy matters still lead to reaffirmations too frequently."³⁰⁷ Although debtors always could pay their debts voluntarily, the elimination of enforceable reaffirmations "is a significant factor in making bankruptcy relief an effective remedy. It ensures that a debtor will not come out of bankruptcy in the same situation as when he went in."³⁰⁸

Complete prohibition of reaffirmations in the 1978 Code turned out to be politically untenable. The Senate bill was amended on the stated basis that prohibiting reaffirmations would "deprive consumers of a right they have always had, that is, of renewing a debt discharged in bankruptcy. . . . Without this right consumers will be denied the opportunity to protect a cosigner . . . or to protect collateral . . . or to honor a moral obligation . . . What is wrong with reaffirmation if it is voluntary?"³⁰⁹ Another Senator agreed, noting that "it is inherently American to offer somebody a protected route to dignity."³¹⁰ The latter views led to a compromise position. Thus, the new Bankruptcy Code permitted reaffirmations but imposed a series of procedural prerequisites to filter out reaffirmation agreements that were not in the debtors' best interests.³¹¹

Requirements Under the Bankruptcy Code of 1978. When originally enacted, the Code gave courts a central role in the creation of enforceable reaffirmation agreements. The Code required a court to determine that the agreement did not impose an undue hardship on the debtor. A court also had to decide that the agreement actually was in the debtor's "best interest."³¹² If a reaffirmation agreement

³⁰⁷ H.R. No. 9200, 95th Cong., 1st Sess., § 524 (1977), S. 2266, 95th Cong., 1st Sess., § 524 (1977). House Report, Appendix C, COLLIER ON BANKRUPTCY, App. Pt. 4-1047 (Lawrence P. King et al eds. 15th ed. rev. 1997).

³⁰⁸ *Id.*

³⁰⁹ *Id.* at 4-2199-2201.

³¹⁰ *Id.* at 4-2201.

³¹¹ Courts have invalidated some postpetition debt that really is dischargeable debt under the guise of new debt when the parties have not comported with the section 524(c) requirements. Cases in which courts have invalidated reaffirmation agreements for this reason include the following: *In re Getzoff*, 180 B.R. 572 (B.A.P. 9th Cir. 1995); *In re Artzt*, 145 B.R. 866 (Bankr. E.D. Tex. 1992); *In re Gardner*, 57 B.R. 609 (Bankr. D. Me 1986); *In re Gilliland*, 62 B.R. 587 (Bankr. D. Neb. 1986). Of course, courts only can officially invalidate these post petition arrangements when these agreements are brought to their attention, and it is difficult to say how frequently this occurs.

³¹² "Best interests" was construed to mean financial or economic interest. See *In re Avis*, 3 B.R. 205 (Bankr. S.D. Ohio 1980).

did not pass these tests, the agreement was disallowed. The Code also established procedures for the approval of related agreements to redeem collateral and settlements of nondischargeability actions, which would be enforceable only if the court found that the agreements were made in good faith.³¹³ In all cases, the court was required to hold a hearing on the proposed reaffirmation of debt. At that hearing, the court would admonish the debtor that the agreement was entirely voluntary and explain the legal consequences of reaffirmation. The debtor had an absolute right to change her mind within thirty days.

Changes in 1984. The Consumer Credit Amendments in the Bankruptcy Amendments and Federal Judgeship Act of 1984 substantially modified section 524(c). A reaffirmation was not valid unless the debtor's attorney submitted an affidavit stating that the agreement would not cause the debtor undue hardship. The 1984 amendments also instituted several boilerplate disclosure statements and a longer rescission period after the agreement was filed with the court. These amendments generated disagreement over the extent that court involvement was still required for reaffirmation agreements to be enforceable.³¹⁴ At the same time, the amendments seemed to narrow the scope of agreements that might be reaffirmed by eliminating from section 524(c) any mention of settlements of nondischargeability actions.³¹⁵

Changes in 1994. To the extent any lingering confusion remained about the lack of court involvement in the reaffirmation process, the Bankruptcy Reform Act of 1994 clarified that court hearings on reaffirmations were not required when attorneys representing the debtors in reaffirmation negotiations signed the requisite affidavits.³¹⁶ The 1994 legislation also made modest changes to the boilerplate disclosure requirements; the reaffirmation agreement would have to "clearly and conspicuously" advise the debtor that the agreement is not required under bankruptcy or nonbankruptcy law.³¹⁷ To support the reaffirmation, the attorney affidavits would have to state that the debtor was fully advised of the reaffirmation agreement's legal effect and consequences. As always, technical noncompliance with the elements of

³¹³ 11 U.S.C. § 524(c)(4) (1994).

³¹⁴ Compare *Arnhold v. Kyrus*, 851 F.2d 738 (4th Cir. 1988) with *In re Sweet*, 954 F.2d 610 (1992).

³¹⁵ 11 U.S.C. § 524(c) (1994).

³¹⁶ *Id.* § 524(d) (1994).

³¹⁷ Some courts have said that a statement that is not set off by distinctive type or print size is not "clear and conspicuous" and have refused to allow the agreements. *In re Noble*, 182 B.R. 854 (Bankr. W.D. Wash. 1995), citing *In re Wallace*, 102 B.R. 54, 56 (Bankr. E.D.N.C. 1989).

sections 524(c) and (d) could render the reaffirmation agreement unenforceable,³¹⁸ assuming that the debtor knew to question the enforceability of an agreement. Because court hearings no longer were part of the ordinary course, only upon later challenge would the validity come into question.

Current Use of Reaffirmations. Through all of these statutory permutations, experience with reaffirmations under the 1978 Code has demonstrated that the existing procedural statutory constraints have not accomplished the intended goals. In 1978, few policymakers may have contemplated that completely- or partially-unsecured debts would be reaffirmed routinely, but the data suggest that this is precisely what is happening.

In 1981, about 19% of the debtors who filed for Chapter 7 bankruptcy reaffirmed one or more debts.³¹⁹ Given the express Congressional intent to restrict access to reaffirmations, the number seemed surprisingly high at the time. By 1996, according to a national survey of bankrupt debtors conducted by Visa, 52% of the debtors reported reaffirming one or more debts.³²⁰

The majority of debts that are reaffirmed are at least partially secured by personal property. For example, debtors frequently reaffirm car loans.³²¹ Secured creditors ask debtors to reaffirm their personal obligations on secured debts so that if a debtor retains the property and subsequently defaults on the loan, the lender can repossess the property and can sue the debtor personally for any amount that resale did not cover.

³¹⁸ See, e.g., *Marquette Bank Coon Rapids v. Kirby*, 209 B.R. 128 (Bankr. D. Minn. 1997) (under pre-1994 amendment law, failure of parties to attend reaffirmation hearing where admonitions would be given rendered reaffirmation agreement unenforceable, thus denying creditor's motion for summary judgment for over \$20,000 plus costs); *In re Noble*, 182 B.R. 854 (Bankr. W.D. Wash. 1995) (agreement unenforceable without rescission clause and with other disclosure requirements not in clear and conspicuous form); *In re Perryman*, 111 B.R. 227 (Bankr. E.D. Ark. 1990) (absence of clear and conspicuous statement that agreement may be rescinded rendered agreement unenforceable).

³¹⁹ TERESA SULLIVAN, ELIZABETH WARREN & JAY L. WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* 32 (1989).

³²⁰ VISA CONSUMER BANKRUPTCY REPORTS, *CONSUMER BANKRUPTCY: BANKRUPTCY DEBTOR SURVEY 12* (July 1996). Professors Culhane and White report that they find 28.1% of the debtors had one or more reaffirmations in their files. Marianne Culhane and Michaela White, Memorandum to National Bankruptcy Review Commission, Creighton Bankruptcy Reaffirmation Project Preliminary Results, Table 19 (September 23, 1997).

³²¹ *Id.* Table XZ, *Reaffirmations by Type of Collateral* (30% of reaffirmations were for car loans).

Many creditors request and obtain reaffirmations for unsecured debt. According to the Creighton Bankruptcy Reaffirmation Project, 22% of reaffirmation agreements in their sample were for totally unsecured consumer debts,³²² although more than half of the reaffirmations filed are for unsecured, nominally secured, or undersecured debt.³²³ Anecdotal evidence and testimony to the Commission from a variety of parties generally supports this inference. In those instances, debtors reaffirm their personal obligations on debt but keep no property in return.

Reaffirming a debt that is not secured by essential property raises significant questions about whether any such agreement can be in the debtor's best interest.³²⁴ When the original version of section 524(c) was drafted, few people expected the provision to be used for frequent reaffirmation of unsecured debts. Theories differ on why debtors agree to reaffirm unsecured debts. Some might reaffirm because the debt is co-signed and they want to protect the co-signer.³²⁵ Others may reaffirm out of moral obligation on certain debts. These debtors could voluntarily repay without creating an agreement that could be sued on in court.

Perhaps the most frequent reason debtors give for reaffirming unsecured debts is simply because creditors asked them to reaffirm.³²⁶ Although the Bankruptcy Code unambiguously prohibits a creditor from taking any act to enforce or collect a debt following a bankruptcy filing, some courts have ruled that creditors are free to solicit reaffirmations actively without running afoul of the law.³²⁷ When asked, debtors may

³²² Culhane and White, Creighton Bankruptcy Reaffirmation Project, Tables (Sept. 23, 1997).

³²³ *Id.*; see also Letter from Jeffrey A. Tasse, Senior Vice President, Government and Legal Affairs, American Financial Services Assoc., (Jan. 21, 1997) (realistic rate of reaffirmations for "Big Three" automobile lenders would be 30-40% of their Chapter 7 debtor borrowers, yielding approximate total of 107,000 reaffirmations in 1996).

³²⁴ See 3 COLLIER ON BANKRUPTCY ¶ 524.04, p. 524-37, n.9 (15th ed. 1996) (citing case issued prior to BAFJA).

³²⁵ See Letter from Tom Symmonds, Manager, Lower Columbia Longshoremen's Federal Credit Union, Longview, WA (June 9, 1997) (recounting circumstances in which his customers reaffirm debts, including to protect a co-signer).

³²⁶ See Steve Miletich, *For Many Debtors, It's All in the Cards; Easy Credit Under Fire As Bankruptcy Soars*, SEATTLE POST-INTELLIGENCER (May 5, 1997) (reporting on reaffirmation solicitation practices).

³²⁷ A creditor may be able to solicit reaffirmations from debtors without violating the automatic stay. *In re Duke*, 79 F.3d 43 (7th Cir. 1996) (letter sent to debtor and attorney explaining reaffirmation options did not violate stay); accord *Brown v. Pennsylvania State Employees Credit Union*, 851 F.2d 81, 84 (3d Cir. 1988) (union notice containing "mild" warning that it would bar

not realize that they are entitled to say “no.” Some debtors’ attorneys refuse all requests for reaffirmations,³²⁸ while others believe that debtors can benefit from carefully chosen reaffirmation agreements.³²⁹ However, other attorneys apparently believe that they should not interfere in the reaffirmation decision. In the absence of zealous, well-informed counsel, many debtors commit to significant postdischarge obligations. The burden of economically unwise reaffirmations falls especially hard on the debtors who have the fewest resources to hire careful counsel.

Creditors offer another explanation for reaffirmations of unsecured debt: they offer extensions of new credit, possibly on more competitive terms. Congress originally sought to address this type of arrangement when enacting the Code, as Congressman Butler explained at those hearings in 1978:

The evidence before us was overwhelming that a practice has developed to follow a discharge in bankruptcy with a reaffirmation of debt in consideration of an expanded debt. A debtor could come through bankruptcy to discharge a loan of \$500 and find himself borrowing another \$500 in order to get back on his feet. As a condition to the new loan the debtor is required by the lender to reaffirm the discharged debt, and as a result the debtor owes \$1,000. We felt this option was being exploited.³³⁰

As the legislators recognized in the 1970s, the economic effect of reaffirming a large amount of discharged debt can completely undermine the debtor’s financial rehabilitation. In fact, the debtor can be substantially worse off than if the debtor paid higher interest rates for postpetition credit. Take, for example, a debtor that reaffirms

debtor from membership absent a reaffirmation did not violate stay). *But see In re Walker*, 194 B.R. 165 (Bankr. E.D. Tenn. 1996) (agreement accompanying letter soliciting reaffirmation did not comport with section 524 and imposed an unfair time limitation on the debtor, and therefore violated section 362(a)(6)). However, courts may find problems with reaffirmation solicitations or agreements that contain coercive language. *See In re Iappini*, 192 B.R. 8 (Bankr. D. Mass. 1995).

³²⁸ See Letter from Deborah A. Kloberdans, Bath Maine (August 1, 1997); Letter from Henry J. Sommer, Miller, Frank & Miller, Philadelphia, PA (October 8, 1996) to National Bankruptcy Review Commission (recommending elimination of provisions in section 524 permitting reaffirmations); See also letter from Paula E. Langguth, Author, *Bounce Back from Bankruptcy*, to Brady Williamson (July 2, 1997)

³²⁹ See, e.g., Royce E. Wallace, Wichita, KS (April 16, 1996) (reaffirmations of secured debt can be helpful to debtors); Letter from the Offices of Eric Taylor, St. Louis, MO, (June 20, 1997) (reaffirmation on secured debts can be beneficial to debtors when debtors have missed payments previously).

³³⁰ Statement of Rep. M. Caldwell Butler, 124 Cong. Rec. H11047 (September 28, 1978).

\$1,500 of debt to receive a credit line of \$2,000 (including the \$1,500 of pre-bankruptcy debt) at 15%. Purely on economic terms, that debtor would be better off discharging the \$1,500 of past debt and borrowing \$500 of new credit at 22%. The reaffirmation cannot be justified as a bargain for the debtor. In addition, extensions of credit in exchange for reaffirmations are not necessarily at advantageous rates when some lenders still charge 21% or higher, even with a reaffirmation.³³¹

The current reaffirmation requirements specifically mandate an attorney affidavit stating that the proposed reaffirmations do not cause undue hardship to their clients. Recent practices suggest that some attorneys sign these affidavits with little or no attention to this requirement. The Honorable John Akard of Texas wrote to the Commission in the final days of preparing this report to submit a reaffirmation agreement signed by debtors in his court. The agreement committed them to repay a loan on a pick up truck that cost \$18,027.71 over fifteen years. With compounded interest, the debtors would pay a total of \$42,861.84. Judge Akard asked the debtor's attorney about the length of the payout, at which time "the attorney admitted overlooking that fact."

In a memorandum opinion annulling a reaffirmation agreement, a bankruptcy court in New York showed that some calculations clearly indicate the undue hardship caused by some reaffirmed debts, even if the debtor receives an extension of credit:

In this case, the debtor understood by reaffirming \$1,800 of her prepetition indebtedness of \$2,380.94, she would be extended \$500 in new or additional credit. . . . Had the debtor immediately drawn down the \$500 in "new credit" and had not made any principal reductions on that \$500 credit extension for the next twelve months, then she would be obligated to pay every month: (a) the monthly finance charge on the \$500 balance at an actual annual percentage rate of 21%, (b) \$43 a month as the scheduled reaffirmation payment, and (c) a monthly finance charge on the \$1,800 reaffirmed debt. So for the putative advantage of obtaining and using \$500 of new credit, she would be required to pay about \$950 in finance charges for the first year under the terms of the reaffirmation agreement.³³²

³³¹ See Culhane & White, Creighton Bankruptcy Reaffirmation Study, Table 64 (Sept. 23, 1997); Reaffirmation Interest Rates by Category (mean interest rate for unsecured debt was 19.28%, while mean interest rate on quasi-secured debt was 19.28%, and mean interest rates on debt secured by clothing, furniture and electronics were between 19.54 and 22.76%); Mary Kane, *Creditors Happy to Lend to Bankrupt Consumers; New Credit Lines Often Are Higher*, NEW ORLEANS TIMES-PICAYUNE, (June 20, 1997) (reporting, for example, that one retailer was charging 21%).

³³² *In re Bruzzese*, No. 897-80807-288 (Slip Op.) (Bankr. E.D.N.Y. Sept. 10, 1997).

Credit on nearly any terms would be superior to the economic reality of these terms. Yet, the debtor's attorney had signed the affidavit stating the debtor was fully advised of the consequences of the proposed reaffirmation, and that the attorney believed that the agreement would not impose an undue hardship, even though the debtor already had a negative monthly cash flow of over \$750.³³³

Numerous empirical studies show that Chapter 7 debtors have debt burdens that far exceed their capacity for repayment.³³⁴ To the extent that some debtors have gotten into these circumstances by underestimating their inability to handle that debt,³³⁵ reaffirmations exacerbate this problem. Preliminary results of the Creighton Bankruptcy Reaffirmation Project reveal that debtors in all districts studied did not have adequate monthly income to meet both their monthly expenses and the reaffirmed debt payments.³³⁶ Even debtors who reaffirmed no housing debt reaffirmed an average of over 23% of their total incomes, *excluding* interest on the reaffirmed debt.³³⁷ When Chapter 7 debtors emerge from bankruptcy so greatly encumbered by debt, they are hindered from regaining financial security. Reaffirmations could be an important factor leading to repeated bankruptcy filings.

As noted earlier, the burden of reaffirmations may fall hardest on the debtors who do not have the assets or the savvy to work the bankruptcy system to their advantage. Some debtors find lawyers who steer them clear of all reaffirmation

³³³ *Id.* See also *In re Hovestadt*, 193 B.R. 382 (Bankr. D. Mass. 1996) (reaffirmed debt would cause debtor to have negative cash flow according to schedules, and yet attorney signed affidavit stating that reaffirmation would not cause undue hardship). See also Letter from Hon. Arthur J. Spector, Bankruptcy Judge, E.D. Mich. to Melissa Jacoby, (May 20, 1997) (providing tapes and transcripts of reaffirmation hearings involving multiple reaffirmations that exceeded debtors' ability to pay); *In re Lantanowich*, 207 B.R. 326 (Bankr. D. Mass 1997) (debtor agreed to repay \$1,000 plus interest to obtain line of credit of \$200).

³³⁴ Statement of Ian Domowitz, Department of Economics and Institute for Policy Research, Northwestern University, before the Subcommittee on Administrative Oversight and the Courts of the Senate Judiciary Committee, April 11, 1997, pp. 8-10 (refuting the empirical foundation for the credit industry's "needs-based" bankruptcy proposal); TERESA A. SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989); Culhane & White, Creighton Bankruptcy Reaffirmation Project, Revised Table 63, 63a1.(Sept. 23, 1997).

³³⁵ Lawrence Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 250 (1997) (draft presented to the National Bankruptcy Review Commission in February 1997).

³³⁶ Culhane & White, Creighton Bankruptcy Reaffirmation Project Revised Table 63 (Sept. 23, 1997).

³³⁷ *Id.* at Table 22bX.

agreements. Others find clever attorneys who help them obtain very carefully chosen reaffirmations and discharge all other debts when they otherwise would file for Chapter 13. Yet other debtors have attorneys who do not closely monitor reaffirmations, and still others who have no attorneys at all. It is ironic that the most basic element of the consumer bankruptcy system – the fresh start – would be denied to the debtors least able to protect themselves.

Many parties have suggested that the modern economy requires a credit card. A family may not be able to rent a car or reserve a motel room without one. However, a bankrupt debtor need not reaffirm a debt to get a credit card. Based on data collected between 1978 and 1988, researcher Michael Staten noted “a surprising willingness of creditors to quickly issue revolving credit to former bankrupts who were not previous customers.” He observed that this credit was available from a “broad cross-section of creditors.”³³⁸ Since that time, access has expanded considerably. The media continues to report on the availability of new credit to debtors following bankruptcy.³³⁹ A representative of one creditor explained that post-Chapter 7 debtors are “low-risk customers. They’re rid of all their old outstanding debt and they can’t file bankruptcy again for years.”³⁴⁰ Consumer representatives concur that credit is available to post-Chapter 7 consumers.³⁴¹

Even if credit cards were not readily available for debtors who have filed for bankruptcy, it may be unwise to permit reaffirmations just so bankrupt debtors can get more postbankruptcy access to credit, which often exacerbated debtors’ initial

³³⁸ Michael Staten, *The Impact of Post-Bankruptcy Credit on the Number of Personal Bankruptcies*, Credit Research Center Working Paper No. 58, p.8-9 (1993).

³³⁹ See, e.g., Mary Kane, *Creditors Happy to Lend to Bankrupt Consumers; New Credit Lines Often Are Higher*, NEW ORLEANS TIMES-PICAYUNE, (June 20, 1997) (reporting that some Visa and MasterCard issuers pursue newly bankrupt debtors through mail solicitations); Peter G. Gosselin, *Big Spenders bring debt to the Masses; Overspending often follows new access to quick cash*, BOSTON GLOBE (March 2, 1997) (reporting on subprime and low-income lending generally).

³⁴⁰ *Id.*, citing Rick Pontalion, who represents Capital One, Montgomery Ward, Levitz, Discover, and other creditors.

³⁴¹ See National Consumer Law Center, *Fair Credit Reporting Act Changes Affect Bankruptcy*, NCLC Reports; Bankruptcy and Foreclosures Edition 11 (1996) (“consumers who are concerned about obtaining new credit following bankruptcy should always be told that there are many creditors who grant credit to recent bankruptcy debtors. In some cases these days, new offers of credit are made even before the debtor’s existing case is completed . . . Consumers should also be told that they will need to make a special effort to shop for credit following bankruptcy. They should not simply assume that they will have to pay a higher interest rate or offer significant collateral”).

financial troubles.³⁴² The bankruptcy process should encourage debtors to focus more on savings and spending within one's means.

Other Implications of current reaffirmation practices. The high volume of reaffirmation agreements — both filed and unfiled — in the consumer bankruptcy system affects debtors' financial rehabilitation, but several other types of problems with reaffirmations also have been identified throughout the Commission's consumer bankruptcy discussions.

Equality of Distribution. Equality of distribution is one of the central premises of the collective bankruptcy process. Under state law collection practices, when a debtor has insufficient assets to pay all creditors in full, the swiftest or most aggressive creditor often can obtain the lion's share. The creditors' race to the courthouse ceases when a debtor files a bankruptcy petition. The Bankruptcy Code prescribes the distribution of available assets in accordance with statutory priorities, and creditors holding debts of the same priority share *pro rata*. If a Chapter 7 debtor had \$100 of nonexempt assets to distribute to general unsecured creditors, she would not be permitted to give all \$100 to one general unsecured creditor and leave the others with nothing.

When a debtor signs a reaffirmation agreement, she agrees to commit a certain portion of her future income to pay one unsecured creditor to the exclusion of all others. This is inconsistent with the principle of equality of distribution to creditors that is central to the collective bankruptcy process. The high volume of repayment obligations outside the structure of a Chapter 13 payment plan magnifies different treatment of similarly-situated creditors.

The inequality is particularly troubling because the benefits of reaffirmations are not spread evenly throughout the creditor body. The current bankruptcy process incidentally provides opportunities that promote this inequality. Section 341 of the Bankruptcy Code requires that every debtor attend a meeting to be subject to questioning by the case trustee or creditors. Instead of questioning debtors on the record, however, it seems that the 341 meeting is often used for another purpose. The Commission heard repeated testimony that creditors attend these meetings so they can deal directly with the debtors in the hallways before or after the meeting to request that the debtors reaffirm their debts. Attorneys reported that creditors routinely solicited their clients directly while attorneys attended to other clients. Clients already had been convinced to sign by the time attorneys got involved. The small group of creditors that are able to monitor the bankruptcy process obtain a

³⁴² See, e.g., *Comments on Recent Increases in Delinquencies and Defaults on Consumer Loans, Testimony to the Committee on Banking and Financial Services*, H.R., 104th Cong. 2d Sess. 104-74 at 369 (September 12, 1996) (statement of George M. Salem, CFA, noting that several attorneys report that debtors continuing to receive unsolicited card offers).

significant proportion of the reaffirmations in the system, many on nominally or wholly unsecured debts, while other creditors get nothing. One newspaper account recounts the story of “The Bon Lady,” a retailer representative who follows debtors out of the courthouse in attempts to convince them to reaffirm their debts.³⁴³

Unlike these creditors, other parties that are creditors in fewer bankruptcies may not find it cost-effective to stand in the courthouse hallways to solicit reaffirmations. In addition, creditors who follow the most conservative, careful postbankruptcy credit practices may not be willing to dun debtors in bankruptcy for further payments. As a result, the bankruptcy system, as presently constituted, rewards the largest and most aggressive creditors. For the remainder, the promise of “equity is equality” in bankruptcy is a hollow promise.

Because of the current reaffirmation provisions, some creditors obtain 100% repayment while creditors with equal priority get nothing. In a business Chapter 11 cramdown case, such a result would be deemed “unfair discrimination” and disallowed.³⁴⁴ Yet, it is condoned in a consumer Chapter 7. The bankruptcy system was not intended to foster disparate treatment among creditors with similar priorities, but the current reaffirmation system creates opportunities for some creditors to receive substantially better treatment than others.

Effect of Reaffirmations on Incentives to File Chapter 13. By obtaining a reaffirmation, a creditor generally enjoys far better treatment than if the debtor had filed for Chapter 13. In most instances in Chapter 13, an undersecured debt would be bifurcated into secured and unsecured portions. The secured creditor would be entitled to payment in full only on the secured portion of the loan. On the unsecured portion, the creditor would receive only *pro rata* distribution along with all other holders of unsecured claims. With respect to unsecured debts, a reaffirmation in Chapter 7 entitles an unsecured creditor to get 100% repayment, significantly more than the creditor would have received in most Chapter 13 cases.

When Congress originally debated the inclusion of reaffirmations in the Bankruptcy Code of 1978, the members did not speak in terms of using reaffirmation as a debt collection device. Repayment of creditors was to be accomplished using a collective, cheap, efficient and fair Chapter 13 repayment plan in accordance with specific statutory priorities. Now, some creditors fare much better by using reaffirmations than they would in Chapter 13 repayment plans where they would have to share the debtor’s future income with other creditors.

³⁴³ See Steve Miletich, *For Many Debtors, It's All in the Cards; Easy Credit Under Fire As Bankruptcy Soars*, SEATTLE POST-INTELLIGENCER (May 5, 1997).

³⁴⁴ See 11 U.S.C. § 1129(b) (1994).

Debtors' incentives also must be considered. Currently, well-counseled debtors can structure a very beneficial bankruptcy using a combination of Chapter 7 and reaffirmations of debt. A debtor's incentive to file for Chapter 13 is diminished by the opportunity to reaffirm selected debts in Chapter 7. Any debtor who sees a benefit in repaying some creditors has little reason to file for Chapter 13 if that benefit can be obtained through a Chapter 7 discharge coupled with one or two privately negotiated reaffirmation agreements.

To the extent that the Bankruptcy Code reduces the opportunities for the debtor and one creditor to negotiate a private arrangement for future payments, the debtor's incentives to file for Chapter 13 diminish. If Chapter 13 repayments, with specified priority of payment and equality of distribution, are a preferred alternative for debtors, reaffirmation options should be sharply curtailed.

The Commission's Recommendation. All of the aforementioned considerations were part of continuous discussions involving hundreds of people throughout the Commission's deliberative process. On the basis of these considerations, the Commission concluded that current reaffirmation practices are inconsistent with promoting repayment in Chapter 13, equal treatment of creditors, and financial rehabilitation of debtors. Therefore, the Commission recommends that reaffirmations of unsecured debt be eliminated. To be consistent with that position, the Commission recommends that secured debt reaffirmations be limited to the value of the collateral. The reaffirmation agreement could not include additional amounts, such as attorney's fees or other collection costs.³⁴⁵ The debtor would bear the burden of producing information about the value of the property, although any party in interest could request a judicial valuation of the collateral. Limiting the reaffirmation of debt to the value of the property would provide the creditor with either the property upon surrender or the equivalent cash value of that property over time. Viewed from this perspective, this approach is fair and consistent with the way that secured claims generally are treated in the bankruptcy process.

Filing reaffirmation agreements with the court would continue to be a fundamental requirement. This creates a public record of the terms of the agreement and permits the court or any other party to see if the required disclosures were made to the debtor. Although hearings would not be required in all cases when debtors' attorneys signed the requisite affidavits, court approval of these reaffirmations would be re-introduced to ensure that the requirements have been met. Courts could hold hearings in any case at their discretion, as some courts do now.

³⁴⁵ In the event that the lender is oversecured, this approach diverges from the general rule of section 506(b) of the Bankruptcy Code. Under section 506(b), if the collateral securing a loan is worth more than the remaining debt, a secured creditor may be entitled to fees and costs up to the value of the collateral if the original loan agreement so provides.

The Recommendation offers clear direction on the procedures and the information required regarding the collateral, the debt, and the basis of their valuation. The recommended requirements and the corresponding proposed form were derived in part from studying the forms that many districts have adopted pursuant to local rule in the past several years.³⁴⁶ In many districts, therefore, this Recommendation would not cause a significant change in practice. This Recommendation allocates responsibility to debtors' attorneys to assist their clients in negotiating and preparing this critical paperwork. The court would need to ensure that the documentation showed a valid, nonavoidable lien and supported valuation of the property for the amount to be reaffirmed. As is delineated in the proposed statutory language appended to this chapter, court hearings would be required in some instances when the documentation was inadequate.

In all cases, the court and/or the debtor's attorney must determine that the agreement serves the best interest of the debtor and does not impose an undue hardship before the agreement would be enforceable. The success and integrity of the bankruptcy system is the responsibility of not only the bankruptcy bench but of the bankruptcy bar as well. Debtors' attorneys should narrowly and strictly construe the "best interest of the debtor" requirement, as this is a critical component of zealous representation. Reintroducing this element for represented debtors responds to earlier-cited evidence that some attorneys are not taking the undue hardship analysis seriously.

1.3.2 An additional subsection should be added to section 524 to provide that the court shall grant judgment in favor of an individual who has received a discharge under section 727, 1141, 1228, or 1328 of this title for costs and attorneys fees, plus treble damages, from a creditor who threatens,

³⁴⁶ See, e.g., Local Bankruptcy Rules for the United States Bankruptcy Court for the District of Montana, Rule 4008-1, Local Bankruptcy Forms, Forms 10, 10A; Local Rules of Bankruptcy Procedure for the District of Arizona 4008-1, Local Sample Forms 4008-1, 4008-2, 4008-3, 4008-4; Local Rules of the United States Bankruptcy Court for the Eastern District of Washington, Local Form 4008, Appendix A; Local Rules of the United States Bankruptcy Court for the District of Wyoming, Local Bankruptcy Forms, Application for Approval of Reaffirmation Agreement; Local Rules of the Bankruptcy Court for the District of Massachusetts, Standing Order on Requirements of Reaffirmation Agreement, Form 35; Rules of the United States Bankruptcy Court for the Eastern District of Oklahoma, Rule 11(B)(2); Local Rules of the United States District Court and Bankruptcy Court for the Southern District of West Virginia, Rule 8.05; Local Rules of the United States District Court for the Northern District of West Virginia, Local Rules of Bankruptcy Procedure, Rule 4.03; Maine Local Bankruptcy Rules, 4008-1; Set of Local Rules for the United States Bankruptcy Court for the District of Minnesota, Form 4008-1. See also Local Rules of the United States Bankruptcy Court for the Middle District of Louisiana Form 1 (Information required in attorney declaration); Local Court Rules of the United States Bankruptcy Court for the Western District of Texas, Rule 4008; Local Bankruptcy Rules of the United States Bankruptcy Court for the Northern District of Texas, Rule 4008; Local Bankruptcy Rules of the United States Bankruptcy Court for the Southern District of Texas, Rule 4008.

files suit, or otherwise seeks to collect any debt that was discharged in bankruptcy and was not the subject of an agreement in accordance with subsections (c) and (d) of section 524.

A bankruptcy discharge operates as an injunction against attempts to collect prepetition debts that were discharged in the bankruptcy. Postpetition agreements to establish personal liability for discharged debts are not enforceable.³⁴⁷ Likewise, pre-discharge agreements to establish personal liability are not enforceable if they do not comport with the reaffirmation requirements.³⁴⁸

The easiest requirement to check is whether a reaffirmation has been filed with the court. The bankruptcy files are full of reaffirmation agreements; the Creighton Bankruptcy Reaffirmation Study found that reaffirmation agreements could be found in over 28% of the case files in the sample.³⁴⁹ However, the aforementioned Visa survey reported that 52% of the debtors surveyed reported reaffirming one or more debts to their creditors.³⁵⁰ If both data are accurate, only about half of the reaffirmations that creditors are actually using as a basis to bill the debtors meet even the threshold test of enforceability.³⁵¹

While unfiled reaffirmation agreements are not legally enforceable, many debtors presume the enforceability of agreements they have signed. An individual may continue to pay bills every month as they arrive in the mailbox and believe that she must surrender property if she cannot maintain the payments. State courts also

³⁴⁷ *Arnold v. Stevenson Federal Credit Union*, 206 B.R. 560 (Bankr. N.D. Ala. 1997); *In re Getzoff*, 180 B.R. 572 (B.A.P. 9th Cir. 1995); *In re Artzt*, 145 B.R. 866 (Bankr. E.D. Tex. 1992); *In re Gardner*, 57 B.R. 609 (Bankr. D. Me. 1986).

³⁴⁸ *See, e.g., In re Gardner*, 57 B.R. 609 (Bankr. D. Me. 1986); *In re Hovestadt*, 193 B.R. 382 (Bankr. D. Mass 1996).

³⁴⁹ Culhane & White, Creighton Bankruptcy Reaffirmation Project, Table 16/19 (Sept. 23, 1997).

³⁵⁰ Visa Consumer Bankruptcy Reports, Consumer Bankruptcy: Bankruptcy Debtor Survey 12 (July 1996). Professors Culhane and White report that they find 28.1% of the debtors had one or more reaffirmations in their files. Culhane & White, Creighton Reaffirmation Project, Table 19 (Sept. 23, 1997).

³⁵¹ *See In re Turner*, 208 B.R. 434, 436 (Bankr. C.D. Ill. 1997) (as result of streamlining of reaffirmation process, problems have occurred in Central District of Illinois and elsewhere, “including the filing of unsecured reaffirmation agreements where the debtors received nothing in return, the filing of reaffirmation agreements without creditors’ signatures, and the filing of reaffirmation agreements purportedly in settlement of non-dischargeability proceedings where the potential exists for debtors to be strong-armed into an agreement that will not be reviewed by the Court”).

may be misled: unfiled reaffirmation agreements can look exactly like valid reaffirmation agreements. Therefore, these agreements have provided the basis for certain retailers to collect debts in violation of the discharge injunction.

Perhaps the strongest evidence of widespread lack of compliance with the law has come from the creditors themselves. Sears, one of the nation's largest retailers, was the first to admit that it exercised "flawed legal judgment."³⁵² These problems were revealed publicly when an individual in Massachusetts wrote to the bankruptcy judge who had presided over his prior bankruptcy case, stating that he was overwhelmed by his monthly bills and that he was having trouble feeding his children.³⁵³ There was no reaffirmation agreement with Sears in his court files, but Mr. Lantanowich, who was unrepresented, had signed an agreement provided by Sears and thought that he was obligated to pay those bills as they became due.

Mr. Lantanowich was not alone in his assumption that he was bound to pay the monthly bill for discharged debt. The Federal Trade Commission estimates that Sears collected from an estimated 250,000 individuals and families without following the legal procedures expressly required in the Bankruptcy Code.³⁵⁴ Sears has admitted that it improperly collected payments from these debtors and has agreed to a more than \$200 million settlement with various state and federal government agencies.

One judge has opined that the discovery of Sears' practices was just "a tiny tip of a very large iceberg."³⁵⁵ Already, May Department Stores, Co. (Filene's and Lord & Taylor),³⁵⁶ GE Capital Services (issuing cards for Montgomery Ward and Lechmere),³⁵⁷ Federated Department Stores (Bloomingdales and Macy's),³⁵⁸ and

³⁵² Robert Berner, *Sears Debt-Collecting Policy Was Ruled Illegal Twice by a Bankruptcy Judge*, WALL ST. J., A4 (April 25 1997).

³⁵³ *In re Lantanowich*, 207 B.R. 326 (Bankr. D. Mass. 1997).

³⁵⁴ Gerard Meuchner, Bloomberg News, *Lenders' Squeeze tactics Assailed; Pressuring Bankrupt Clients Draws Regulators Scrutiny*, PITTSBURGH POST-GAZETTE (September 11, 1997).

³⁵⁵ Gerard Meuchner, Bloomberg News, *Lenders' Squeeze tactics Assailed; Pressuring Bankrupt Clients Draws Regulators Scrutiny*, PITTSBURGH POST-GAZETTE (September 11, 1997) (citing Hon. Keith M. Lundin, Bankruptcy Judge, M.D. Tenn.).

³⁵⁶ See Bruce Mohl, *Filene's hit with suit over debt collection; Class action alleges retailer engaged in same illegal practices as Sears*, BOSTON GLOBE, April 23, 1997); *Update on May Class Action and Call for Assistance from Class Counsel*, 6 CONSUMER BANKR. NEWS 21 (July 31, 1997).

³⁵⁷ See, e.g., Bruce Mohl, *Lechmere linked to debt probe; Credit Card holders sue parent company Montgomery Ward; Lechmere Parent latest retailer alleged to break debt-collection laws*,

AT&T Universal face similar allegations. After auditing of its own practices, Federated acknowledged that almost 18% of its reaffirmation portfolio since 1990 is improper. Likewise, GE Capital has “acknowledged in court papers that it might not have informed bankruptcy judges in some cases that the agreements existed.”³⁵⁹ The finance arms of both Ford and Chrysler also are being reviewed for the same practices.³⁶⁰ The attorneys general of a number of states reportedly are investigating dozens of lenders for collecting debts through these measures in express contravention of the Bankruptcy Code procedures.

It is unclear whether these experiences will have a significant longterm change in some creditors’ practices.³⁶¹ Courts and consumer advocates have called into question other approaches to collecting debt postbankruptcy. Former accounts of bankrupt debtors are being sold or assigned to other entities who seek to collect discharged debt, either by offering new credit cards in exchange for payment or by initiating postbankruptcy repossession actions in efforts to have debtors sign “postdischarge property retention agreements.”³⁶² The latter arrangement is the subject of a class action suit in Rhode Island.³⁶³

Because it already has been shown that hundreds of thousands of debtors have been the subjects of postbankruptcy collection activity over the past several years, strengthening the provisions protecting the discharge injunction is warranted. Federal law must be clear that creditors cannot pursue collection of debts that have been discharged in bankruptcy or use threats as a collection device. The Commission

BOSTON GLOBE, (April 29, 1997).

³⁵⁸ See Vicki M. Young, *Federated Will Pay \$4.3 Million to Bankrupt Credit Card Debtors*, 174 CAP. CITIES MEDIA INC. 8, 22 (1997).

³⁵⁹ See, e.g., Bloomberg News, *G.E. Reviewing Credit Dispute*, N.Y. TIMES, August 30, 1997, at 31.

³⁶⁰ Gerard Meuchner, Bloomberg News, *Lenders’ Squeeze tactics Assailed; Pressuring Bankrupt Clients Draws Regulators Scrutiny*, PITTSBURGH POST-GAZETTE (September 11, 1997).

³⁶¹ The President of Sears has told the press that Sears planned to continue to collect aggressively from bankrupt debtors. Barnaby J. Feder, *The Harder Side of Sears*, N.Y. TIMES, July 20, 1997.

³⁶² See, e.g., *In re Brown*, LA97-16062-LF, Order to Show Cause re “Willful and Intentional Violation of Discharge and Sanctions,” (U.S. Bankr. Ct. C.D. Cal. September 17, 1997) (unpublished order) (issuing order to show cause for lender and Bankruptcy Recovery Network that solicited property retention agreement from unrepresented debtor).

³⁶³ See Mark J. Rodriguez, et al. v. Bankruptcy Recovery Network, Adv. No. 96-1141 (Bankr. D. R.I. 1996).

recommends a statutory amendment to section 524 that would authorize a court to impose fees and treble damages on a creditor who violates the discharge injunction.

The Bankruptcy Code provides that nothing in the discharge provisions prevent a debtor from making voluntary repayments on a discharged debt.³⁶⁴ None of the Commission's Recommendations would alter this provision. Debtors who feel moral obligations to pay particular debts can attempt to do so, without reaffirming their personal liability. For example, nothing in the Bankruptcy Code prevents an individual from voluntarily paying back \$20 that had been borrowed from a neighbor or family member prior to bankruptcy. Debtors' attorneys, case trustees, and the courts could make debtors aware of this fact. Creditors are free to keep payments that the debtor willingly remits, but a creditor's expectation of voluntary payment is legally unenforceable.

1.3.3 *No Ride-Through*

Section 521(2) should be amended to clarify that a debtor with consumer debts that are secured, as determined by the provisions of title 11, by property of the estate must redeem the property or obtain court approval of an agreement under section 524(c) of title 11 in order to retain the property postdischarge, except for a security interest in real or personal property that is the debtor's principal residence.

Although personal liability is discharged in bankruptcy, a secured creditor retains the right to proceed in *in rem* against its collateral unless the Bankruptcy Code provided for the avoidance of the lien.³⁶⁵ If a debtor defaulted on the loan agreement prior to the bankruptcy, the creditor's right to repossess is clear. If the debtor remained current on the loan obligation prior to the bankruptcy filing and intends to remain current, however, it is unclear whether a debtor is entitled to retain the property and continue paying notwithstanding the intervening bankruptcy case. In the search for resolution, many courts have looked to section 521(2), which was added to the Code in 1984 and requires debtors to state their intentions with regard to collateral. As options, the provision lists surrender, reaffirmation, and redemption. Currently, there is a split in authority over whether this provision substantively and exhaustively defines debtors' options and obligations regarding collateral, or whether section 521(2) is simply a notice provision that has no

³⁶⁴ 11 U.S.C. § 524(f) (1994).

³⁶⁵ *See, e.g.*, 11 U.S.C. § 522(f) (1994).

substantive effect on other rights and entitlements under bankruptcy or nonbankruptcy law.³⁶⁶

This is one subject on which quite a few circuit courts of appeals have spoken, but unfortunately they have not reached the same results. Some permit ride-through if the debtor was current in her monthly payments at the time of filing for bankruptcy.³⁶⁷ Others interpret section 521 to provide a literal bill of rights with regard to the property and thus perceive redemption or reaffirmation to be the only avenues to an entitlement of continued possession after bankruptcy.³⁶⁸

This split in authority is disadvantageous to both debtors and creditors. Once again, the effect of bankruptcy on their property rights and obligations varies depending on the debtor's geographical location. A car lender doing business nationwide must keep apprised of the districts allowing the obligations to ride-through and the districts where the lender will be able to repossess the car once the stay is lifted if the debt is not reaffirmed. If debtors subsequently default, the car lender can sue the reaffirming debtors but not the ride-through debtors. Although many lenders may not find it economically beneficial to sue potentially judgment-proof borrowers for small deficiency judgments, this patchwork of rights and obligations inserts needless complication and cost into the system. The Code should provide a clear rule.

When the Commission initially recommended a complete ban on reaffirmations, it also recommended that the Code explicitly recognize ride-through. A ban on reaffirmations, plus ride-through, would enable debtors to retain property while discharging personal liability if debtors were current on the obligations when they filed for bankruptcy or if the creditor waived the default. The creditor would be entitled to full contract payment, even if undersecured, and a subsequent default on the contract would trigger the creditors' rights to repossession.

³⁶⁶ *Mayton v. Sears, Roebuck & Co.*, 208 B.R. 61 (B.A.P. 9th Cir. 1997) (reviewing various positions, determining that section 521(c) is notice statute and does not provide creditor with substantive rights to force surrender, although postdischarge creditor could pursue remedies under state law).

³⁶⁷ *Capital Communications Federal Credit Union v. Boodrow*, Civ. No. 96-5078, 1997 WL 564226 (2nd Cir. Sept. 12, 1997) (permitting retention of collateral without reaffirmation or redemption); *In re Belanger*, 962 F.2d 345 (4th Cir. 1992); *Lowry Federal Credit Union v. West*, 882 F.2d 1543 (10th Cir. 1989) (same). See also *Mayton v. Sears, Roebuck & Co.*, 208 B.R. 61 (B.A.P. 9th Cir. 1997); *Sears Roebuck & Co. v. Lamirande*, 199 B.R. 221 (D. Mass. 1996); *First N. Am. Nat'l Bank v. Doss*, 203 B.R. 57 (Bankr. W.D. Va. 1996); *In re Ogando*, 203 B.R. 14 (Bankr. D. Mass. 1996); *In re Parlato*, 185 B.R. 413 (Bankr. D. Conn. 1995).

³⁶⁸ *In re Johnson*, 89 F.3d 249 (5th Cir. 1996) (per curiam) (no retention of collateral without reaffirmation or redemption), *In re Taylor*, 3 F.3d 1512 (11th Cir. 1993) (same), *In re Edwards*, 901 F.2d 1383 (7th Cir. 1990) (same). *In re Bell*, 700 F.2d 1053 (6th Cir. 1983).

Those who strongly endorse the ride-through argue that the bankruptcy filing should not trigger a right of repossession when there is no other default. However, because the debtor would have no personal liability, some creditors expressed concern about the protection of their interests that were secured by personal property, the value of which could easily decline. They wanted debtors to have an incentive to take care of the collateral and felt that personal liability provided that incentive. At the same time, others were critical of the ride-through approach because it permits secured creditors to collect both the secured and unsecured portion of the debt. Thus, according to these parties, ride-through does not further the equitable treatment of creditors or provide the debtor with the proper financial rehabilitation emerging from bankruptcy.³⁶⁹

When the Commission reconsidered this approach and decided to endorse limited reaffirmation rights for certain secured debts, it then became logical to reverse its position on ride-through and recommend that the Code not provide an independent right to retain property. Creditors with debts secured by personal property retained by the debtor would be protected by both *in rem* rights and the debtor's personal liability to the extent of the value of the collateral. The tradeoff of this arrangement for a creditor is that the value of the collateral may be less than the amount remaining due on the contract. The unsecured portion would be treated like all other unsecured debts and discharged. Therefore, ride-through might have yielded a greater return to creditors, albeit with the risk of declining value and no recourse against the debtor personally.

While the Commission does not take a position on the proper reading of the current statute that has caused the split in the circuit courts, the Commission recommends that ride-through not be permitted. The Chapter 7 debtor who did not reaffirm in accordance with section 524(c) or redeem the property would have no bankruptcy basis for preventing the creditor from seeking to repossess the property postdischarge.

The Commission recommends retention of one exception to this rule: consistent with current practice, mortgages on the debtor's primary residence could ride through at the contract rate if they were not in default (other than due to the filing of the bankruptcy petition). Of course, the debtor would be expected to meet all other contract terms, including insurance requirements, and ultimately pay the

³⁶⁹ See, e.g., Letter from Marianne Culhane and Michaela White regarding the VISA/Staten Consumer Debtor Study and reaffirmations (June 12, 1997); Hon. C. Michael Stilson, Bankruptcy Judge - N.D. - Ala. Comments on the National Bankruptcy Review Commission Consumer Bankruptcy Working Group's May 6, 1997 Draft 3 (June 6, 1997) (noting that allowing ride-through at full contract amount permits undersecured creditor to receive payments on unsecured part of debt, which violates principle of equitable treatment of creditors and recommending prohibition on reaffirmations of all debts other than secured debts in Chapter 7 and requiring that reaffirmations only be allowed up to value of collateral).

mortgage loan in full. Preliminary results of the Creighton Bankruptcy Reaffirmation Project indicate that of home owners in Chapter 7, only 11% of debts on personal residences were reaffirmed, even though a high percentage of the debtors retained their homes.³⁷⁰ This may be partly related to the fact that quite a few state legislatures already impose restrictions on the ability and extent to which mortgagees can collect deficiency judgments from consumer debtors.³⁷¹ Unlike cars, which diminish in value if poorly maintained, real property generally retains its value over time, and therefore personal liability for a deficiency plays a lesser role.

Effect of these Recommendations on Credit Unions. Many creditor groups have expressed concern about a more restrictive reaffirmation policy, including one creditor group that distinguishes itself in its approach to consumer credit: nonprofit credit unions. Credit unions generally seem to scrutinize the creditworthiness of their members before extending credit, and they work closely with their members facing financial difficulty. The results of their practices pay off: credit unions' chargeoffs are only a tiny fraction of the losses of most credit card issuers. Although, the percentage of chargeoffs due to bankruptcies may have increased,³⁷² their overall default rates, especially as compared to industry default rates, are extremely low.³⁷³ If a debtor files for bankruptcy, credit unions, like other creditors, use reaffirmation agreements to cut their losses on riskier consolidation loans, but also as a tool in their efforts to work with bankrupt members.³⁷⁴ Because the Commission's Recommendations permit some reaffirmations of secured debt, some of the initial concern expressed by credit unions has been addressed. As far as unsecured debt is concerned, this Proposal does not bar debtors from voluntarily repaying an unsecured debt as they

³⁷⁰ Culhane & White, Creighton Reaffirmation Project, Table 34b (Sept. 23, 1997).

³⁷¹ See, e.g., John Mixon & Ira B. Shepard, *Antideficiency Relief for Foreclosed Homeowners: ULSIA section 511(b)*, 27 WAKE FOREST L. REV. 455, 475 and accompanying notes (1992).

³⁷² See National Association of Federal Credit Unions Bankruptcy Survey Results, Percentage of Charge-offs Due to Bankruptcy (May 1996) (44.5% of chargeoffs due to bankruptcy in 1995, 39.4% in 1994, and 41% in 1993).

³⁷³ See, e.g., Testimony of Robert V. Burns, Multco Credit Union, Portland Oregon, to National Bankruptcy Review Commission (December 17, 1997)(overall default rate of fraction of one %); Letter from Joe Irish, Collections Officer, Fergus County Federal Credit Union (July 16, 1997) (same).

³⁷⁴ See, e.g., Letter from Perry Caliguiri, President and CEO, First Iowa Community Credit Union, West Des Moines, Iowa (July 30, 1997) (reporting that reaffirmations on car loans help credit union work with debtor as well as providing excellent collection tool for credit union).

work with their credit unions.³⁷⁵ It may be worthwhile for Congress to study more closely the question of whether nonprofit credit unions that work with their bankrupt debtors as part of an education and credit rehabilitation program should be treated differently from other creditors as a general matter.³⁷⁶ However, as the Commission considered the system as a whole, the benefits of reaffirmations in this context did not outweigh the justifications for restriction.

Note on Redemption. Another approach to retaining collateral in Chapter 7 is redemption of property.³⁷⁷ When a debtor redeems a piece of property, she submits the value of the property to the creditor in satisfaction of the debt and owns the property outright. The money used to redeem property sometimes may be obtained from postpetition loans or the liquidation of exempt property. Redeeming higher value property, such as a car, is not feasible for most Chapter 7 debtors. Rather, the redemption option is more viable for items with a lower outstanding balance. The Commission's Recommendations would not alter this option.

1.3.4 *Security Interests in Household Goods*

Household Goods Worth Less Than \$500

Section 522(f) should provide that a creditor claiming a purchase money security interest in exempt property held for personal or household use of the debtor or a dependent of the debtor in household furnishings, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry, implements, professional books, tools of the trade or professionally prescribed health aids for the debtor or a member of the debtor's household must petition the bankruptcy court for continued recognition of the security interest. The court shall hold a hearing to value each item covered by the creditor's petition. If the value of the item is less than \$500, the petition shall not be granted; if the value is \$500 or greater, the security interest would be recognized and treated as a secured loan in Chapter 7 or Chapter 13.

³⁷⁵ See Letter from Jerry Affolter, Collection Manager, Community America Credit Union, Overland Park, KS (July 29, 1997) (noting that 20% of debtor's loan balances are repaid on voluntary basis, along with 50% of loan balances that are reaffirmed).

³⁷⁶ See Letter from Scott A. Guerin, Treasurer/Manager, Leominster Employees Federal Credit Union (April 29, 1997) (asking why credit unions should be punished along with credit card companies that use less stringent lending practices "who write off in a day what we loan out in a year?").

³⁷⁷ 11 U.S.C. § 722 (1994).

The ability to reaffirm secured debts, combined with the nonavailability of the ride-through, makes it especially important to be clear about what constitutes a secured debt. One might expect that secured debts are easily distinguishable from unsecured debts, but this is not always the case. Individuals with retail charge accounts at some stores might be surprised to learn that every purchase they make is technically a “secured purchase.” This means that the retailer has the right to repossess or threaten to repossess everything bought with the credit card, from pantyhose to shampoo, because retailers in some states automatically obtain a purchase money security interest in those items.³⁷⁸ These security interests are far less formal than security interests on homes and cars.³⁷⁹ Procedures for obtaining and perfecting security interests in cars or homes are relatively elaborate. Creditors are careful in their documentation, and consumers are aware of the security interests and the consequences of default. Valuation of the collateral is an important part of the loan transaction and the interest rates are typically lower than those of unsecured credit, reflecting the asset-based nature of the loan.

Secured loans in household goods can be a perfectly legitimate financing mechanism. Some creditors do rely on the value of the collateral when they extend purchase money credit for expensive household goods that may have some resale value following a default and repossession. However, other loans “secured” by low value consumer goods are not asset-based loans. Creditors’ charge card applications purport to give the creditor a security interest in any item bought on credit, and every charge slip might contain boilerplate language evidencing a security interest in items purchased, whether the consumer bought a vacuum cleaner, a toaster, or a package of bubble gum.³⁸⁰

³⁷⁸ See *In re Hardage*, 99 B.R. 738 (Bankr. N.D. Tex. 1989) (sales slip created security agreement in consumer goods when slip stated that Sears retained security interest); *In re Ziluck*, 139 B.R. 44 (S.D. Fla. 1992) (credit card application and agreement containing language that security interest is being granted creates security agreement; “all merchandise charged” is sufficient description of collateral); *In re Hance*, 181 B.R. 184 (Bankr. M.D. Pa. 1993) (sales slip specifically granting security interest in goods purchased constituted security agreement); *In re Anderson*, 23 B.R. 130 (Bankr. D. Neb. 1982) (security interest in consumer goods retained by retailer via revolving charge agreement and sales slips); *In re Martinez*, 179 B.R. 90 (Bankr. N.D. Ill. 1994) (valid security agreement in consumer electronic products where debtor signed credit agreement that contained clause stating that “all merchandised charged” was collateral).

³⁷⁹ A purchase money security interest in consumer goods that complies in all other respects with the Uniform Commercial Code need not be recorded. U.C.C. § 9-302(1)(d) (“A financing statement must be filed to perfect all security interests except the following . . . (d) a purchase money security interest in consumer goods; but filing is required for a motor vehicle required to be registered”).

³⁸⁰ *In re Ganders*, 176 B.R. 581 (Bankr. N.D. Okla. 1995) (upholding purchase money security interest in goods purchased with retail charge card when payments first are allocated to service charges and then applied to earliest purchases); *In re Ziluck*, 139 B.R. 44 (S. D. Fla. 1992)

There was no evidence presented to the Commission that credit issuers who take security interests in household goods charge less for credit than those who lend on an unsecured basis; most revolving charge loans are made on the same kind of terms whether they are nominally secured or unsecured. Moreover, creditors taking automatic security interests do not seem to differentiate between credit purchases of items with no resale value (*e.g.*, pantyhose) and items that might have some value to a subsequent purchaser (*e.g.*, jewelry), reinforcing the inference that such lending is not asset-based.

This practice is hardly a new phenomenon. A spokesperson for the Federal Trade Commission attested as follows in the 1970s:

One of the most important and widely abused devices available to the large credit institution is a blanket security interest in household necessities. As a practical matter, our files reflect the fact that household goods are rarely seized. The reason for this restraint on the part of creditors is two-fold. Household goods have little or no direct economic value in the resale market. The mark-ups on low cost furniture and appliances almost always exceed one hundred percent. When financing costs are added, it becomes clear that any intrinsic value which such commodities may have will never come close to offsetting the credit liability secured thereby. The second reason has to do with the unfavorable publicity which attends seizure of intimate family furnishings such as bedding and kitchen wares. This does not however mean that blanket security interests in household property are not used. Virtually every creditor we investigated retained such a lien in all appropriate contracts. Some liens are specific, enumerating furniture, bedding linens, pots and pans, and the like. Others were cast in general form merely applying to every household good for every kind and description. The blanket security interest in household goods, combined with the related boilerplate waiver of statutory exemptions has at least three uses. It is an effective lever for securing refinancings at appropriate stages of the collection cycle. It is used occasionally for limited economic recovery by actual seizure of the property. Finally, a blanket lien on household goods is among the most effective levers available for securing an anticipatory reaffirmation of a debt which is otherwise dischargeable in bankruptcy . . . The Federal Trade Commission's proposed credit practices rule

(signature on credit card application sufficient to validate security agreement that was incorporated by reference); *In re Martinez*, 179 B.R. 90 (Bankr. N.D. Ill. 1994) (unsigned security agreement again incorporated by reference and upheld); *In re Wiegert*, 145 B.R. 621 (Bankr. D. Neb. 1991) (upholding purchase money character of retailer charge agreement); *In re Hance*, 181 B.R. 184 (Bankr. M.D. Pa. 1993) (sales slips incorporated terms of unsigned security agreement).

would prohibit the practice of retaining a blanket security interest in household necessities.³⁸¹

Although courts generally look to state commercial law to determine whether a security agreement in consumer goods is valid,³⁸² bankruptcy law has a long tradition of distinguishing security interests held as collateral for asset-based lending from nominally secured interests in circumstances where the collateral would yield little for the creditors on repossession. This step is necessary to determine the priority among creditors' claims. The bifurcation of secured debts into secured and unsecured components in both business and consumer cases reflects this policy, as the legislative history of the Bankruptcy Reform Act of 1978 illustrates:

Most often in a consumer case, a secured creditor has a security interest in property that is virtually worthless to anyone but the debtor. The creditor obtains a security interest in all of the debtor's furniture, clothes, cooking utensils, and other personal effects. These items have little or no resale value. They do, however, have a high replacement cost. The mere threat of repossession operates as pressure on the debtor to pay the secured creditor more than he would receive were he actually to repossess the goods.³⁸³

When debtors file for Chapter 13 and are able to strip secured loans to the value of the collateral, fewer creditors list themselves as secured creditors based on blanket security interests in household goods. However, Chapter 7 debtors face many more creditors claiming to be secured, leaving it to the debtors and their lawyers, if any, to determine whether contesting the claim will be more expensive than simply paying what is requested.³⁸⁴ As the unfiled reaffirmation problem illustrates, some

³⁸¹ Statement of David H. Williams, Attorney, Division of Special Projects, Bureau of Consumer Protection, Federal Trade Commission, Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, 94 Cong, 1st & 2d Sess. at 758-63 (1975-76) (supporting nonwaivability of federal exemptions and prohibition on reaffirmations). Between 1972 and 1974, the Federal Trade Commission had visited 130 branch offices of 12 major consumer finance companies in 30 states in addition to copying and reviewing 6000 consumer accounts.

³⁸² See *Sears, Roebuck Co. v. Oszejca (In re Oszejca)*, 207 B.R. 41, 45 (B.A.P. 2d Cir. 1997).

³⁸³ H.R. REP. NO. 95-595, 124 (1977).

³⁸⁴ One lawyer has recounted to the Commission the various approaches taken by debtors' lawyers to counter these efforts. He notes that a big percentage of his staff time goes to dealing with nominal security interest claims. By comparison, some debtors' lawyers tell their clients to ignore claims of retailers that they are secured and hope for the best until they file a replevin action. Others charge lower fees and have their clients pay what the creditor demands, regardless of whether the

creditors threaten to repossess items to extract repayment on nominally secured debts.³⁸⁵

Security interests need to be addressed uniformly in the bankruptcy laws to provide equality of treatment to creditors and financial rehabilitation to debtors. A retail charge card debt should not get priority treatment over other credit card debt on the basis of a questionable blanket lien in small ticket household goods. Clarifying this issue is relevant primarily in several contexts. First, these blanket security interests on cash register receipts are used to provide additional leverage to obtain repayment commitments from debtors.³⁸⁶ If reaffirmations are going to be permitted only for secured debts, there needs to be a clear and uniform understanding of what debts are secured and entitled to payment through this mechanism.

Nominal security interests play a large part in another context: allegations of conversion to make an ordinary debt nondischargeable. The following example is often used. An individual purchases a birthday present for his mother and some other items on a retail charge card. A week after presenting his mother with the gift, this individual loses his job, and several months later he files for bankruptcy, having not completely paid off his balance on the retail charge card. Some creditors might allege that because the fine print on the receipt made the debtor's purchases secured debts, the debtor committed the tort of conversion when he gave the gift to his mother and therefore the debt to the retailer is nondischargeable under section 523(a)(6). Although debtors that are able to defend against these lawsuits attain a fair level of success,³⁸⁷ if debtors cannot afford to litigate or their attorneys are reluctant to take on that task, the debtors are likely to agree to repay these debts by settling the actions or signing reaffirmation agreements. This result has yielded preferential treatment to creditors with the most aggressive practices, while the debts of other similar creditors, who do not make such specious allegations, are discharged. Bankruptcy policy and basic fairness do not support this result.

claims are specious. See Letter from Robert R. Weed (June 15, 1997).

³⁸⁵ See, e.g., Barnaby J. Feder, *The Harder Side of Sears*, N.Y. TIMES, July 20, 1997.

³⁸⁶ See, e.g., *In re Hovestadt*, 193 B.R. 382, 385-86 (Bankr. D. Mass. 1996).

³⁸⁷ See, e.g., *In re Wincher*, 210 B.R. 286 (Bankr. E.D. Mich. 1997) (debtor's sale of furniture was not willful and malicious injury when debtor was unaware of security agreement); *In re Crisafi*, 205 B.R. 444 (Bankr. M.D. Fla. 1996); *In re Goyeochea*, 192 B.R. 847 (Bankr. D. Md. 1996) (retailers sell goods with implied consent to give goods as gifts to others, thus not nondischargeable on this basis). But see *Sears Roebuck & Co., v. Taylor*, No. 96-06051-8c7, 1997 WL 418035 (Bankr. M.D. Fla. 1997) (fair market value of collateral excepted from discharge).

Similar to the measure of a few states that enforce purchase money agreements in only limited circumstances,³⁸⁸ the Commission recommends that a creditor who wishes to retain and act on a purchase money security interest in a household good must petition the court to do so. A secured creditor that intends to pursue a security interest following a debtor's Chapter 7 discharge would have to identify the item claimed as collateral and simply present evidence that the single item is worth more than \$500, thus it would remain subject to the security interest. When the property is worth less than \$500, the loan would be treated as unsecured. The \$500 amount was chosen over lower and higher options because it provides a rough representation of the economic point at which a creditor would not likely exercise rights of repossession.³⁸⁹ Creditors have attacked this Proposal as being administratively burdensome. The burden appears, however, to be minimal. It should be emphasized that the Recommendation only would apply to the household goods listed in the Proposal, and not to other items that might be collateral, such as cars.

In making this Recommendation, the Commission does not write on a clean slate. Section 522(f) of the Bankruptcy Code already reflects Congress' understanding that much nominally secured consumer credit has only "hostage" value. This provision enables the debtor to avoid nonpossessory, *nonpurchase* money security interests to the extent they impair exemptions in those items. The Commission's Recommendation would not affect the current operation of that provision. A Federal Trade Commission rule, promulgated several years after the enactment of section 522(f), extends similar protection to nonbankrupt debtors by making it an unlawful practice to take non-purchase money security interests in household items.³⁹⁰

1.3.5 Characterization of Rent-to-Own Transactions

Consumer rent-to-own transactions should be characterized in bankruptcy as installment sales contracts.

³⁸⁸ See e.g., GA. CODE ANN. §10-1-8 (1996) (retail installment contract security interest shall not be taken with respect to clothing, softwares, and other nondurable items); N.Y. PERS. PROP. LAW. § 413(12) (McKinney 1996) (five year limit on enforceability of purchase money security interest in item purchased for less than \$200).

³⁸⁹ Other options that were considered were \$2,500 and \$100.

³⁹⁰ 16 C.F.R. § 444.2 Unfair credit practices. It provides: "(a) In connection with the extension of credit to consumers in or affecting commerce, as commerce is defined in the Federal Trade Commission Act, it is an unfair act or practice within the meaning of section 5 of that Act for a lender or retail installment seller directly or indirectly to take or receive from a consumer an obligation that: . . . (4) Constitutes or contains a nonpossessory security interest in household goods other than a purchase money security interest."

Nonbankruptcy law generally defines the scope of substantive interests such as property rights, contract rights and tort rights for bankruptcy purposes.³⁹¹ Some rights are difficult to characterize under state law or otherwise, but the definition will make an important difference in the relative positions of parties in bankruptcy that compete for a limited pool of resources.

Rent-to-own contracts for personal property present a difficult question of characterization under both state law and bankruptcy law,³⁹² primarily because they contain hallmarks of both a personal property lease and an installment sales contract. When an owner leases personal property, the owner allows another to use the property for a specified time in exchange for specific payments, after which the owner has an absolute right to retain the property. A retail installment sales contract, by contrast, contemplates that the buyer will make payments over time and ultimately will own the property. Because the purchase is subject to a security interest, the contract contemplates return of the property and a possible lawsuit for any deficiency if the buyer defaults. When consumers enter into rent-to-own transactions, they make payments on extended terms for various household and personal items. If they fail to pay, they lose the items, much like a buyer subject to a security agreement. However, they are liable for payments only for the rental term, much like a true leasing arrangement. Like in an installment sale, however, the goal of most rent-to-own contracts is purchase of the item over time.

Whether an agreement between two parties is a lease or an installment sale is a matter of critical importance in any environment. At state law, for example, whether the transaction is a lease or an installment sale triggers different filing requirements. The hybrid nature of this rent-to-own arrangement has led a large number of states to adopt specific rent-to-own legislation.³⁹³ The debtor may have certain nonwaivable rights in an installment sale that are not present in a lease arrangement. The consequences of characterizing a transaction as an installment sale or lease can be even more profound in a collective bankruptcy proceeding. The Bankruptcy Code must determine whether an agreement is a true lease or an installment sale to resolve the relative rights and obligations of those with potential claims against the debtor. The debtor has the option to breach or to perform a lease

³⁹¹ *Butner v. United States*, 440 U.S. 48 (1979).

³⁹² See Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates versus the Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L. J. 385 (1997) (rent to own transaction is hybrid that cannot easily be squeezed into existing statutory framework); Barkley Clark, et.al. *Rent-to-Own Agreements in Bankruptcy: Sales or Leases*, 2 AM. BANKR. INST. L. REV. 115 (1994) (reporting that at least 50 published opinions have discussed this issue).

³⁹³ See Barkley Clark, et.al. *Rent-to-Own Agreements in Bankruptcy: Sales or Leases*, 2 AM. BANKR. INST. L. REV. 115, 117 (1994).

or a contract. If the debtor breaches, the property is returned and the other party can file a claim against the estate for damages under the lease agreement. However, if the debtor performs, the contract must be performed in whole, and the nondebtor party will receive payment in full ahead of all other creditors. For a debtor in Chapter 13, this may require a significant diversion of the debtor's income to pay a single creditor, leaving less for all other creditors. Even in a Chapter 7 case, a contract or lease creditor will receive a greater share that otherwise would go to all the creditors. The debtor's use of the property during the interim period will be an administrative expense priority. If rent-to-own agreements were treated as leases, the vendor would receive superior treatment to other purchase money security interest holders by being entitled to one hundred percent payment and would get the lion's share of assets that otherwise might be available for *pro rata* distribution to all unsecured creditors.

In installment sales, the seller receives payment for the loan's secured portion, but both the payment schedule and the amount of interest to be received can be adjusted in a Chapter 13 plan. The remainder of the loan amount that is not secured by the collateral is treated as an ordinary, unsecured debt, entitling the creditor to a *pro rata* distribution of assets of future income in Chapter 13.

The Proposal is not premised on any subjective determination of the utility of rent-to-own contracts. Rent-to-own contracts have been the subject of attack outside of bankruptcy, with varying results.³⁹⁴ Consumer advocates argue that these rent-to-own contracts are an attempt to avoid various state laws regulating interest rates and lending practices.³⁹⁵ Whether consumer protection laws should prohibit these contracts is beyond the scope of this Commission's work. What is needed in bankruptcy, however, is a characterization of these transactions for determining priority and entitlements. The courts have differed over the appropriate bankruptcy treatment of rent-to-own contracts. Some courts characterize rent-to-own contracts as installment sales creating allowed secured claims, while others treat the contracts as leases that must be performed or breached in full.³⁹⁶ Once again, parties in one

³⁹⁴ See *Fogie v. Thorn Americas, Inc.*, 95 F.3d 645 (8th Cir.) (in certified class action, upholding injunction against rent-to-own company for usurious contracts that effectively charged 48-746%, violating state law), *reh'g en banc denied*, (1996), *cert. denied*, 117 S.Ct. 1427 (1997); *Ortiz v. Rental Management, Inc.* 65 F.3d 335 (3d Cir. 1995) (rent-to-own agreement not credit sale for purposes of truth in lending act because lessee could terminate at any time). See Wade Lambert, *Thorn Must Void Rental Contracts, A Judge Decides*, Wall St. J., Oct. 2, 1995, at B6.

³⁹⁵ See Letter from Consumers League of New Jersey (May 14, 1997).

³⁹⁶ According to the American Bankruptcy Institute's Consumer Bankruptcy Reform Forum Report, a majority of courts treat these agreements as installment sales contracts/secured loans. See, e.g., *South Carolina Rentals, Inc. v. Arthur*, 187 B.R. 502 (D.S.C. 1995)(rent-to-own agreements for appliances created security agreements); *In re Goin*, 141 B.R. 730 (Bankr. D. Idaho 1992) (rent-to-own transaction for freezer and VCR was security agreement under Idaho common law). *But see*

location are treated differently from parties with the same contracts elsewhere. More uniform guidance on the role of these transactions in the bankruptcy priority scheme is necessary to cut wasteful litigation and to make certain that a consistent legal rule is applied.³⁹⁷ This is a dispute over a bankruptcy issue that must be resolved uniformly in the bankruptcy courts, distinct from the province of state legislatures to regulate such agreements for other purposes.

Equality of distribution is the bankruptcy principle that best guides the Commission in resolving the ambiguity over the treatment of rent-to-own contracts. Creditors who sell goods to the debtor are entitled to be treated equally in the bankruptcy process, regardless of the form of the contract they use. A rent-to-own contract, typically aimed toward the purchase of consumer goods, looks more like an installment sale as measured by the parties' intent. If ordinary installment sales creditors are entitled to the rights and subject to the limitations of the Bankruptcy Code, there is no principled reason why rent-to-own creditors should be treated differently.

The American Bankruptcy Institute Consumer Bankruptcy Forum, which included representatives of debtors, creditors, judges, academics, and trustees, unanimously urged the Commission to recommend that all rent-to-own contracts be treated as allowed secured claims rather than as contracts or leases.³⁹⁸ Notably, this was one of few issues at the ABI forum on which all parties voiced agreement.³⁹⁹

Barkley Clark, et.al. *Rent-to-Own Agreements in Bankruptcy: Sales or Leases*, 2 AM. BANKR. INST. L. REV. 115 (1994) (settled in most states that rent-to-own agreement is not installment sale or security interest); *see, e.g.*, *Powers v. Royce*, 983 F.2d 88 (7th Cir. 1993) (under Illinois law, rent-to-own transaction is true lease under Illinois law); *In re Yarbrough*, 211 B.R. 654 (Bankr. W.D. Tenn. 1997) (rent-to-own car transaction is true lease under Tennessee law); *Mr. C's Rent-to-Own v. Jarrells*, 205 B.R. 994 (Bankr. M.D. Ga. 1997) (rent-to-own transaction for air conditioner was true lease); *In re Rigg*, 198 B.R. 681 (Bankr. N.D. Tex. 1996) (rent-to-own appliance contract was true lease under Texas law); *In re Morris*, 150 B.R. 446 (Bankr. E.D. Mo.1992). Still others find that it is neither a lease nor a security interest. *In re Trusty*, 189 B.R. 977 (Bankr. N.D. Ala. 1995) (under Alabama's rent-to-own statute, rent-to-own contract is neither security interest nor true lease, but hybrid commercial arrangement that should be treated as executory contract). Section 1-201(37) of the Alabama Uniform Commercial Code was enacted in 1991 so that rental-purchase agreements would be specifically excluded from the definition of "security interest."

³⁹⁷ "Collectively, the bankruptcy decisions are not very helpful in deciding whether RTO agreements are sales contracts or leases because some courts have held the former and some the latter, depending on their interpretations of varying state laws." Susan Lorde Martin & Nancy White Huckins, *Consumer Advocates versus the Rent-to-Own Industry: Reaching a Reasonable Accommodation*, 34 AM. BUS. L. J. 385, 417 (1997).

³⁹⁸ *See* ABI Consumer Bankruptcy Reform Forum Summary and Report on Options (undate).

³⁹⁹ *Id.*

Both secured and unsecured creditor representatives who participated in these discussions expressed concern about the favorable treatment received by rent-to-own creditors premised on the ambiguous nature of the transaction under state law. They pointed out that the economic consequences of the characterization will be extremely relevant to a debtor's other creditors. If the transaction is characterized as a purchase money security interest/installment sale, the vendor would be treated like other secured creditors.

A similar provision has been considered previously. The Senate bill leading up to the Bankruptcy Reform Act of 1994 originally contained a similar amendment that would have required rent-to-own agreements to be treated as installment sales in bankruptcy. This amendment was endorsed by the Commercial Law League of America, the National Bankruptcy Conference, and the National Association of Chapter 13 Trustees, among others.⁴⁰⁰

⁴⁰⁰ See S. 540 § 316 (defining rent-to-own contracts and providing that they would be treated as installment sales in both Chapters 7 and 13). See also *Hearing Before the Subcommittee on Economic and Commercial Law of the Committee on the Judiciary*, A&P Bankr. 94 Hearings, P.L. 103-394, S. 540 103d Cong., 2d Sess. (August 17, 1994), 102d Cong., 2d Sess., (July 8, 1992).