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How the Debtor Gets to Keep "His Own" Property

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§ 9.1 ~ Introduction

The benchmark in bankruptcy is that the debtor turns over his property to the trustee, who liquidates it and distributes the proceeds to creditors. If there is a creditor with secured debt in an amount that exceeds the value of its collateral, then the trustee may abandon the property and let the secured creditor foreclose.

This may lead to the question: Does the debtor ever get to keep his own property? Surprisingly often, he does. For purposes of this book, the most important devices for retaining property are in chapter 11, which we deal with in detail later. But even under chapters 7, 12 and 13, there are ways a debtor can retain his property. The following is a catalog of a variety of devices that will work to leave property in the hands of the debtor, notwithstanding the claims of the trustee and creditors. Later, we call attention to a couple of devices that will not work.

§ 9.2 ~ Confirm a Plan

Confirm a chapter 11 plan, including a cramdown plan. A classic purpose of chapter 11 is to provide a device whereby the debtor gets to retain property while creditors' claims are disposed of. Cramdown, in which the debtor may "rewrite the contract" and impose it on the secured creditor, is only the most dramatic of plan devices.[1]

Confirm a chapter 13 plan. Chapter 13 provides a "payment plan" process for debtors with a regular income — usually (but not always) wage-earners. Compare also chapter 12 for family farmers (or fishermen). Both chapters include a kind of cramdown.

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1 *See generally infra* Chapter 18 of this book ("The Plan").

§ 9.3 ~ Claim It as Exempt

Claim the property as exempt. Section 522 provides that an individual debtor may claim property as exempt, either under the bankruptcy statute or under non-bankruptcy law. But, as noted above, most states have exercised their statutory right to "opt out" of the federal system, leaving only state exemptions available.[2] Exemptions are available only to individual debtors; entities other than individuals, such as partnerships, corporations and limited liability companies, do not get any exemptions.

§ 9.4 ~ Redeem It

Redeem the property under chapter 7. Sometimes overlooked, § 722 gives the debtor the right to "buy back" collateral from the secured creditor. The important part is that the debtor gets to redeem the property at a court-imposed valuation rather than having to bargain on his own. The right applies only to consumer goods securing a dischargeable consumer debt. It also applies only when the property is exempt or when the trustee is abandoning the property. Debtors must use non-estate property (*e.g.*, a post-petition gift from a rich uncle) to redeem collateral.

Consider Daniel Debtor, who owes $5,000 on his household goods. Although it might cost as much as $6,000 to replace them, the court finds that they are worth only $2,000. Daniel may redeem by paying $2,000. Unfortunately for consumer debtors, they must pay the entire buyback price at the time the right is exercised; no installment payments are permitted.

The redemption right does not seem to be used very much — which is hardly surprising. After all, if the debtor has enough money to pay the lien in full, what is he doing in bankruptcy?

§ 9.5 ~ Buy It Back

Buy back from the estate "in the market." The trustee is supposed to maximize the value of the estate, which means, for practical purposes, he is supposed to sell to the highest bidder. And who is the highest bidder? In some cases it may be the debtor himself. After all, who better than the debtor knows whether that engine leak is really serious or how much change is hidden under the back seat? His "reserve price," as economists like to say, is likely to be higher than anyone else's. Perhaps sadly, his attachment to "his" property may lead him to overpay for goods that he could easily replace more cheaply.

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2 *See supra* § 8.29.

Unfortunately for the debtor, the typical trustee is not in the business of extending credit. A purchase from the trustee, like the redemption, will probably require cash on the line — and the cash will have to come from some place other than the bankruptcy estate.

§ 9.6 ~ Reaffirmation

Enter into a deal with the secured creditor. Consider Delia Debtor, who owes $18,000 to CredCo, secured by her two-year-old sports car, worth only $10,000. She cannot really handle the installment payments on $18,000, and she certainly cannot pony up the cash to redeem under § 722 at $10,000. But with a little extra scrimping, she might be able to continue with payments on $12,000.

Can she make it happen? Of course, she might try to do it as a cramdown in chapter 13, or even 11 or 12, but there are significant hurdles. Nothing requires the secured creditor to take her deal in chapter 7. But the practical fact is that plenty of creditors will be glad to enter into a new contract in which Delia agrees to pay $12,000 over time. Better the new deal, they will reason, than to stand by helplessly while Delia tosses the keys on the table and heads off to ride the bus. And there are a significant number of cases where the debtor will reaffirm the debt without modification of the terms or reduction of the amount due just because he wants to retain his property and may not easily be able to get new credit.

For the creditor, there is one vital threshold here: Per § 524(c) and (d), the reaffirmation agreement must be approved by the court. The criteria for court approval cover a page or two of text, but here are the vital points:

- The deal must be done before the discharge;
- The debtor gets 60 days to rescind;
- The deal must not impose an undue hardship on the debtor; and
- The disclosures to the debtor and the reaffirmation paperwork must comply with the requirements set forth in § 524(k).

Caution: If you represent the creditor in a consumer bankruptcy case, do not even think about skipping the reaffirmation process. Sears — the retailer — found itself in the middle of a costly and embarrassing mess in the late 1990s when it came to light that the company regularly failed to file reaffirmation agreements with the court. The $60 million fine paid by Sears — plus a lot more in parallel civil suits — served as a warning to others.

So much for devices that may help the debtor. Now, we'll consider a couple that may not.

§ 9.7 ~ Soldier On

Consider Delbert Debtor, who owes $26,000 to CredCo secured by the van he uses to cart the kids to school. The van's value is unknown, but it is certainly less than $26,000. Delbert does not have enough cash to redeem under § 722, and CredCo has made it clear that it is in no mood to deal. Moreover, someone told Delbert that even if you are going bankrupt, you need to keep your secured creditors happy — and he has never missed a payment.

What if Delbert just keeps on paying and keeps on driving? He is not in payment default, and ordinarily contract clauses that make the filing of a bankruptcy a default are not enforceable,[3] so Delbert might think that's the easiest solution. Of course, CredCo's lien will ride through the bankruptcy, so if Delbert quits paying later, he may lose the van — but any deficiency claim will be discharged.

Too good to be true? Sadly for the debtor, yes. The relevant language is in § 521(a)(2). The language provides that the debtor must "file with the court a statement of his intention with respect to the retention or surrender of such property" — and he must carry out his intent. So if he is not in default on the car loan, he may be able to keep the car, but only if he reaffirms the debt and keeps up with the payments.

Congress, in 2005, put new teeth in this § 521(a)(2) declaration. Prior to 2005, there was no explicit penalty for ignoring the rule, and a number of judges held in effect that debtors were free to ignore it. But BAPCPA added language to § 362, the section that sets forth the automatic stay against creditor action. Section 362(h) provides that if the debtor does not comply with § 521, the stay terminates and the property is no longer property of the estate, leaving the creditor free to use whatever remedies might have been available had bankruptcy not occurred. In addition, and as an exception to the general rule that bankruptcy default clauses are not enforceable, § 521(d) allows the lienholder to enforce such a clause if the debtor fails to take the required actions. So, unfortunately for Delbert, the "do nothing" option doesn't work.[4]

§ 9.8 ~ The "New Value" Exception

The so-called "new value exception" to the absolute priority rule is an idea that absorbed countless hours of lawyer time and energy in the 1980s and 90s. The idea of the new value exception is to permit the debtor's equity-holders to sidestep the usual order of priorities and retain their equity interests in the debtor, as it reorganizes, by contributing "new value" beyond the assets already available for distribution in the estate.

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3 *See* § 541(c).

4 11 U.S.C. § 362(h)(2) (2013) creates an exception, providing that the stay will not terminate if the trustee convinces the court that the property has "consequential value or benefit to the estate," but the debtor must turn over the property to the trustee and the secured creditor gets adequate protection, so this is a protection for the estate, not the debtor.

The Supreme Court, in an important 1999 decision, made the new value exception much more difficult. It held that in order to do a new value plan, the debtor had to, in some way, "market test" the equity that would be purchased by the old equity-holders, to ensure that the "new value contribution" that they propose to make represents a fair price for the equity they propose to retain.[5] Subsequent cases have explored how this "market test" might be accomplished — potentially through an auction mechanism, or by terminating the debtor's exclusivity, so that others can file competing plans. The *LaSalle* decision did not represent the end of the new value exception, but it made it much harder for equity-holders to retain the equity for a below-market contribution — which was often the goal of these new value plans!

The "new value" issue arises in the context of chapter 11 plan confirmation, so we have placed our discussion of the topic over there.[6]

§ 9.9 ~ Goodbye to Lien-Stripping: Chapter 13

By way of comparison, it may be instructive to consider the treatment of cramdown issues in chapter 13.

> **Example:** Delbert is the owner of a truck that is subject to a secured claim held by NuBank for $50,000. The truck is worth only $40,000. The debtor needs the truck, but it is a stretch to make the monthly payment. NuBank will not make a deal.

Here's a possibility: Impose a "cramdown" plan. Bifurcate the debt into two claims: $40,000 (secured) and $10,000 (unsecured).[7] Rewrite the contract to pay the "secured" claim on terms that Delbert can live with. Pay the unsecured claim *pro rata* with other unsecured claims, perhaps a few cents on the dollar.

Although it is subject to a lot of qualifications, it has often been the way to go for debtors in chapter 11 or chapter 13. In many cases, it still is — but in 2005, Congress knocked a big hole in this strategy for chapter 13 debtors. Chapter 13 now provides that the chapter 13 debtor has to treat the entire $50,000 as a secured claim — no more bifurcation — if the lien is a purchase-money security interest in a motor vehicle acquired for the debtor's personal use, securing a debt incurred within 910 days preceding the bankruptcy or, for any other collateral, incurred within one year prior to the bankruptcy.[8]

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5 *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999).

6 *See infra* §§ 18.17-19.

7 11 U.S.C. § 506(a); *cf. id.* §§ 1325(a)(5) and 1129(b)(2)(A).

8 *Id.* § 1325(a).

You can still "rewrite the agreement," cramdown style, on these purchase-money deals, stringing out the payments even though you cannot reduce the size of the claim. But if the secured claim is "security interest real property that is the debtor's personal residence," you cannot rewrite it at all.[9]

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9 In an earlier episode, clever and enterprising lawyers tried to develop a scheme of lien-stripping in chapter 7, deploying the claims-bifurcation rules of § 506(a), which, as they correctly pointed out, applied in chapter 7 just as much as they did in 11 or 13. The Supreme Court put a stake through the heart of this technique in *Dewsnup v. Timm*, 502 U.S. 410 (1992). In a 2015 case, the Supreme Court was asked to limit the *Dewsnup* decision to "partially– as opposed to wholly–underwater liens." The Court declined to adopt that distinction, but the opinion suggests the same Justices may be rethinking *Dewsnup* and would be willing to entertain a challenge to it. *See Bank of America, N.A. v. Caulkett*, No. 13-1421, 575 U.S. __ (2015).