BANKRUPTCY ISSUES RELATED TO FORECLOSURE AND REPOSSESSION

Prepared and Presented by:

J. Frasher Murphy
Eli O. Columbus
WINSTEAD SECHREST & MINICK P.C.

Foreclosure and Repossession in Texas

Bankruptcy Issues Related to Foreclosure and Repossession

A. Overview of Bankruptcy Code

Once a borrower files for bankruptcy protection, state law debt collection procedures, including repossession and foreclosure, are replaced by federal bankruptcy laws and procedures. A debtor's bankruptcy filing has a significant effect on the manner in which creditors may pursue and seek to enforce claims against the debtor. Bankruptcy law is set forth in Title 11 of the United States Code (hereafter referred to as the "Bankruptcy Code"). The Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") govern the procedures in cases filed under the Bankruptcy Code.[1]

The Bankruptcy Code is organized in eight chapters: 1, 3, 5, 7, 9, 11, 12, and 13. The first three chapters of the Bankruptcy Code, Chapters 1, 3, and 5, contain general provisions governing the administration of bankruptcy cases. Among other things, the first three chapters of the Bankruptcy Code set forth the requirements for who may be a debtor under the Bankruptcy Code, define the assets and liabilities of a bankruptcy estate, define the scope of the automatic stay, and establish the rights, powers, and duties of a trustee. The first three chapters of the Bankruptcy Code, generally, apply to all bankruptcy cases.

Chapters 7, 9, 11, 12, and 13 of the Bankruptcy Code define the different forms of relief available to a debtor. Chapter 7 is a liquidation bankruptcy case. Chapter 9 governs municipal bankruptcies. Chapter 11 is a reorganization form of bankruptcy. Chapter 12 applies only to

---

[1] *See* Fed. R. Bankr. P. 1001, *et seq.*

debtors who qualify as "family farmers under the Bankruptcy Code."[2] Chapter 13 is a reorganization or debt adjustment proceeding which applies to individual debtors with a small level of debt.

As discussed in more detail below, the form of a debtor's bankruptcy will have a significant impact on how creditors' claims are administered. Specifically, the form of bankruptcy case will impact the treatment of secured claims and collateral in different ways. Secured creditors must carefully monitor a debtor's bankruptcy case to assure their rights are protected. Although a debtor's bankruptcy filing brings into effect a wide ranging federal system of laws and procedures to deal with almost all of the debtor's assets and debts, the Bankruptcy Code also contains certain provisions that protect secured creditors.

1. Chapter 7

A Chapter 7 case is a liquidation proceeding for individuals, corporations, and partnerships. Relief is available under Chapter 7 regardless of the amount of the debtor's debts or whether the debtor is solvent or insolvent. Attorneys often refer to Chapter 7 as "straight bankruptcy," as Chapter 7 is designed to allow an individual or business to liquidate all non-exempt assets to pay creditors.

In a Chapter 7 case, the debtor generally keeps any money earned or property acquired after the filing of bankruptcy, free and clear of past debt.[3] Chapter 7 is most often used by individuals who wish to free themselves of debt quickly and fairly inexpensively by way of a

---

[2] Chapter 12 of the Bankruptcy Code has been subject to repeal; however, on October 25, 2004, the President signed into law S.2864, which retroactively extends Chapter 12 for 18 months from January 1, 2004, until July, 2005. Accordingly, during this time period, Chapter 12 cases can still be filed.

[3] Exceptions exist to this general rule. For example, an individual who files a Chapter 7 bankruptcy and subsequently becomes entitled to an inheritance within 180 days after filing bankruptcy must turnover the inheritance to the bankruptcy estate for distribution to creditors.

discharge[4]; however, businesses use the Chapter 7 process to liquidate and terminate their business operations.[5]

A Chapter 7 case begins with the filing of a bankruptcy petition with the bankruptcy court. The commencement of the case creates a bankruptcy "estate," which consists of all legal or equitable property interests of the debtor existing as of the bankruptcy filing date. After filing the bankruptcy petition, the debtor will also file schedules listing all assets and liabilities, as well as the listing of certain property the debtor is allowed to claim as exempt from the bankruptcy. Additionally, the debtor will file a schedule showing current income and expenditures, a statement of financial affairs, and a listing of any executory contracts or unexpired leases to which the debtor is a party.

In every Chapter 7 case, a Chapter 7 Trustee is appointed. Approximately thirty days after a Chapter 7 bankruptcy petition is filed, the Chapter 7 Trustee holds a meeting of creditors. This meeting is often referred to as the "341 Meeting," since this meeting is required by Section 341 of the Bankruptcy Code. The 341 Meeting provides an opportunity for the debtor to be questioned under oath by the Chapter 7 Trustee and any creditors. At the 341 Meeting, the debtor's attorney generally walks the debtor through the schedules filed in the case, and then turns the proceedings over to the Chapter 7 Trustee. At that time, the Chapter 7 Trustee examines the debtor to ensure that the debtor understands the various effects on the debtor of filing bankruptcy (e.g., credit history and the effect of receiving a discharge). Once the

[4] One of the primary purposes of Chapter 7 bankruptcy is to discharge certain debts in order to give an honest debtor a fresh start. Receiving a discharge has the effect of extinguishing the debtor's personal liability on its debt. It is important to note that only individuals may discharge their debts, as corporations and partnerships are not entitled to receive a discharge in Chapter 7.

[5] If a Bankruptcy Court determines that an individual filing Chapter 7 has the ability to pay off his or her incurred debt, the Court will often dismiss the Chapter 7 case for substantial abuse (finding that the debtor has the ability to propose and carry out a meaningful Chapter 13 plan).

Chapter 7 Trustee is satisfied with the information disclosed by the debtor at the 341 Meeting and in the debtor's schedules, the Chapter 7 Trustee provides any creditors present at the 341 Meeting an opportunity to ask questions of the debtor. Some creditors elect to send their attorneys to the 341 Meeting, while other creditors prefer to attend the meeting in person. All creditors are free to ask questions at the 341 Meeting, regardless of whether the creditor is represented by an attorney.

In addition to providing creditors an opportunity to ask questions of the debtor, the 341 Meeting also gives the Chapter 7 Trustee an opportunity to decide whether the Chapter 7 case needs to be closed as a "no-asset" case or treated as an "asset" case to be administered by the Chapter 7 Trustee. All Chapter 7 cases are deemed to be "no-asset" cases at the time of filing. This designation simply means that nothing remains for creditors after the debtor's exemptions are set aside. If the Chapter 7 Trustee determines after the 341 Meeting that no assets remain for distribution to creditors, the Chapter 7 Trustee will simply file his or her case report and the case will be closed. On the other hand, if the Chapter 7 Trustee determines that assets do exist for distribution to creditors, the Chapter 7 Trustee will file his or her report indicating so and the estate will be administered.

In an asset case, the primary role of a Chapter 7 Trustee is to liquidate the debtor's non-exempt assets in a manner that maximizes the distribution to the debtor's unsecured creditors. A Chapter 7 Trustee generally abandons property subject to a secured creditors' security interests and liens, unless that property has significant equity that could be distributed to unsecured creditors. Unless encumbered property has significant equity, Chapter 7 Trustee's generally decline to administer encumbered property because such an exercise produces little or nothing for unsecured creditors.[6]

In addition to liquidating the non-exempt assets of a debtor's estate, the Trustee also pursues causes of action to recover money or property. This exercise is often referred to as the Chapter 7 Trustee exercising his or her avoidance powers under Chapter 5 of the Bankruptcy Code (avoidance issues are discussed in more detail in Section D herein).

After the Chapter 7 Trustee liquidates the estate and pursues any available avoidance actions, the Chapter 7 Trustee typically reviews the claims filed against the estate. At this time, the Trustee will file objections to any claims that appear inaccurate or are unsupported by sufficient documentation and proof. After notice and a hearing, the bankruptcy court will determine whether to allow or disallow claims to which the Trustee lodged objections.[7]

Once the Trustee's claim objections are resolved, the Trustee is in position to make distributions to creditors. If a secured creditors' collateral has not been abandoned or otherwise administered (i.e., auction sale) through the course of the Trustee's administration of the case, the secured creditor will either receive the property itself or the value of such property.[8] The Trustee will then distribute funds to creditors holding administrative claims (e.g., claims for actual, necessary costs and expenses of preserving the estate) and priority claims (e.g., claims for unpaid wages, taxes, commissions). After payment of secured claims, administrative claims, and priority claims, the Chapter 7 Trustee distributes any remaining unencumbered funds in the estate to unsecured creditors on a pro rata basis.

---

[6] Occasionally, secured creditors are able to negotiate with the Chapter 7 Trustee to reach an agreement whereby the Trustee will administer the secured creditors' collateral in exchange for a portion of the proceeds of such collateral to be distributed to unsecured creditors.

[7] Many objections are resolved by agreement between the Chapter 7 Trustee and the party filing the claim in advance of a hearing on the objection.

[8] In some cases secured debt may also "float through" the bankruptcy case as discussed in more detail in Section C herein.

2. Chapter 13

A Chapter 13 case is a reorganization proceeding for individuals. A Chapter 13 case can generally be thought of as a consumer debt adjustment case. Only an individual with regular income that owes as of the date of the bankruptcy filing, unsecured debts of less than $290,525.00 and secured debts of less than $871,550.00 are eligible for relief under Chapter 13.[9] Under Chapter 13, the debtor remains in possession of all property and proposes a plan to restructure its payment obligations. A trustee is appointed in all Chapter 13 cases.[10] In many regions, there is a standing Chapter 13 Trustee that is appointed to all Chapter 13 cases.[11] The Trustee's primary role in a Chapter 13 case is to collect monthly plan payments from the debtor and make distributions to creditors pursuant to the terms of the plan.

A Chapter 13 debtor is required to file a plan with the bankruptcy petition or within fifteen days after filing for bankruptcy.[12] There are various requirements the plan must meet in order to be approved. Among other things, the plan must provide for the submission of all of the debtor's future earnings or income, or a portion of such earnings, to the Trustee in an amount sufficient for execution of the plan.[13] Additionally, the plan must provide a distribution to unsecured creditors in an amount at least equal to what they would receive in a Chapter 7 liquidation.[14]

---

[9] 11 U.S.C. §109(e) (an individual with regular income and such individual's spouse are both eligible for relief under Chapter 13 as long as their combined unsecured debt is less than $290,525.00 and their combined secured debt is less than $871,550.00).

[10] *See* 11 U.S.C. §1302.

[11] *See* 28 U.S.C. §586(b).

[12] Fed. R. Bankr. P. 3015(b).

[13] 11 U.S.C. §1322(a)(1).

[14] 11 U.S.C. §1325(a)(4).

A Chapter 13 debtor has several options regarding the treatment of secured claims. The debtor can simply choose to surrender the collateral to the secured creditor.[15] However, the very reason many debtors file Chapter 13 is so they can retain possession of their property, including property subject to liens. In order to retain collateral in Chapter 13, the debtor must either reach an agreement with the secured creditor regarding the treatment of the claim, or provide for the payment of the secured claim in full.[16]

Unless the creditor agrees otherwise, the proposed treatment of a secured claim in a Chapter 13 plan must provide for the payment in full of the secured claim valued as of the effective date of the plan. Accordingly, the plan must provide for the payment of interest to compensate the secured creditor for having its claim paid over the duration of the plan instead of receiving the value of its collateral immediately as it would in a Chapter 7 liquidation. Additionally, the plan must provide that the secured creditor retain its lien to secure payment of its secured claim under the plan.[17] In many Chapter 13 cases, the debtor and creditor agree to the terms of payment and interest rate.[18] The United States Supreme Court recently issued an opinion regarding the test for determining an appropriate interest rate for the payment of secured claims in cases where the secured creditor objects to the proposed treatment of its claim in the plan. In *Till v. SCS Credit*, a plurality of the Supreme Court adopted a "formula approach" in which the bankruptcy court starts with the national prime rate and then adjusts the prime rate to

---

[15] 11 U.S.C. §1325(a)(5)(6).

[16] 11 U.S.C. §1325(a)(5)(A), (B).

[17] 11 U.S.C. §1325(a)(5)(B).

[18] In some instances, the debtor in Chapter 13 cases simply proposes to continue making direct payments to the secured creditor pursuant to the terms of the original loan agreement.

account for the increased credit risk that bankruptcy debtors pose.[19] Because various facts and circumstances must be considered in determining the risk factors to make an adjustment to the prime rate, the bankruptcy court must hold a hearing to permit the debtor and creditors to present evidence regarding the appropriate risk adjustment.[20]

Although a debtor can use Chapter 13 to modify the payment schedule for certain secured debts, Chapter 13 contains an exception to the secured debt adjustment provisions for debts secured by the debtor's principal residence. Debts secured by the debtor's principal residence are expressly excluded from the Chapter 13 provisions that allow debtors to alter the treatment of secured claims through a plan.[21] Thus, in order to keep a home subject to a mortgage in a Chapter 13 case, the debtor must comply with the original terms of the mortgage loan. However, the debtor can use the Chapter 13 plan to cure existing defaults on home mortgage payments, because the restriction on modification of home mortgage claims applies only to future payments.[22] The debtor is required to cure existing defaults within a reasonable time under the plan.[23] Chapter 13 allows the debtor to cure existing defaults on a home mortgage loan and then pay the loan pursuant to its original terms going forward, even if the loan had been accelerated prior to the bankruptcy filing.[24] As long as the debtor files for bankruptcy prior to a foreclosure sale, existing defaults can be cured pursuant to the plan, but then all payment obligations going

---

[19] *Till v. SCS Credit*, 124 S.Ct. 1951 (2004).

[20] *Id.*

[21] 11 U.S.C. §1322(b)(2).

[22] 11 U.S.C. §1322(c); *See also* 11 U.S.C. §1322(b)(3) and (5).

[23] 11 U.S.C. §1322(b)(5).

[24] 11 U.S.C. §1322(c)(1).

forward cannot be altered.[25]

3. Chapter 11

A Chapter 11 bankruptcy case is also a reorganization proceeding; however, it is more widely available to parties than Chapter 13. Chapter 11 is available to individuals, but it is typically used for reorganizations of corporations and partnerships. The purpose of Chapter 11 is to allow a business or individual time to reorganize and continue its business or financial affairs without liquidation of assets. During the case, the debtor remains in control of its assets[26] and must file a plan of reorganization, which contains a proposal to pay creditors out of property of the estate or future profits or earnings. Because the debtor remains in control of its assets, the debtor is given the title "debtor-in-possession."[27]

Like Chapter 7 and Chapter 13 cases, a Chapter 11 bankruptcy begins with the filing of a bankruptcy petition. In most cases, the debtor-in-possession also files a number of "first-day" motions. The term refers to the group of fairly common motions that are filed by debtors on the first day of a Chapter 11 case. More importantly, the term also refers to the corresponding orders that most debtors hope to have entered on the first day of the case or very shortly thereafter. These motions and the resultant orders range from the fairly mundane procedural motions, such as those requesting the joint administration of numerous affiliated bankruptcy cases, or maintaining the use of existing cash management systems to motions requesting substantive relief such as requests for approval of post petition financing, use of cash collateral, payment of critical vendors, and other similar motions.

---

[25] *Id.*

[26] A Trustee may be appointed in a Chapter 11 case upon a showing that the debtor is acting fraudulently, dishonestly, incompetently, or is guilty of gross mismanagement of the affairs of the debtor.

[27] In the event of an appointment of a trustee, the debtor is no longer a "debtor-in-possession."

The relief sought by debtors in first day motions forms the foundation for the Chapter 11 case, as this relief is generally designed to stabilize the debtor's operations and enable the debtor to continue operating in the ordinary course of business.

Soon after the filing of a Chapter 11 case, the United States Trustee appoints an official committee of unsecured creditors.[28] The creditors' committee typically consists of persons holding the largest unsecured claims against the debtor. The goal of the creditors' committee members is to protect and represent the interests of the unsecured creditors by serving as a watchdog of sorts on behalf of the larger body of creditors it represents.

After the first day motions are heard by the bankruptcy court, a debtor will typically begin taking actions in furtherance of its eventual plan of reorganization. This often includes motions filed with the bankruptcy court for authority to sell assets of the estate that the debtor no longer believes are necessary or vital for continued operations.[29] Many times, a large corporation will sell the assets of one or more unprofitable subsidiaries in hopes of reorganizing around a leaner, more profitable group of operations. Sale motions are particularly important to secured creditors because a secured creditor with a lien on the assets proposed to be sold should review the proposed sale terms to ensure that the secured creditor is to receive the proceeds from the sale in an amount that is satisfactory to the secured creditor.[30] Secured creditors should also be mindful that a debtor or creditors' committee[31] may attempt to surcharge the secured creditor for the costs and expenses of such sale if the sale does not yield benefits to any party other than

[28] The United States Trustee has the discretion to not appoint committee if circumstances warrant (*e.g.*, small case, small number of unsecured creditors or small amount of unsecured debt).

[29] Motions to sell assets of the estate are brought pursuant to Section 363 of the Bankruptcy Code.

[30] Generally, if the proposed sale is to yield less than the amount of the secured creditors' indebtedness, the debtor must obtain the secured creditor's consent to move forward with the sale under Bankruptcy Code Section 363(f).

[31] Surcharge actions belong to the debtor's estate; however, under certain circumstances, creditors can obtain authorization from the bankruptcy court to bring derivative actions on behalf of the estate.

the secured creditor.[32]

Although the preparation, confirmation, and implementation of a plan of reorganization is the heart of the Chapter 11 process, a number of other matters routinely occur during the course of a Chapter 11 case. In addition to asset sales and first day motions, these events may include the assumption and rejection of executory contracts and unexpired leases, the initiation of adversary proceedings (i.e., lawsuits), the filing of objections to claims filed by creditors (similar to the Chapter 7 process, but handled by the debtor-in-possession rather than a Chapter 7 Trustee), and defending against motions for relief from the automatic stay filed by creditors.

Once a debtor is ready to prepare and file its Chapter 11 plan, it must make sure that its proposed plan meets a number of detailed requirements set forth in Section 1123 of the Bankruptcy Code. For example, a plan must group similarly-situated creditors in their respective classes. Furthermore, the plan must propose to pay each creditor at as much as that creditor would receive if the debtor had filed a Chapter 7 bankruptcy (unless the creditor agrees to accept less on its claim). In addition to the plan meeting specific requirements under Section 1123, the Bankruptcy Code also requires a debtor to prepare a disclosure statement to accompany the plan of reorganization.

Similar to a disclosure statement prepared by a public company, a debtor's disclosure statement is designed to give creditors adequate information concerning to affairs of the debtor to enable the creditor to make an informed judgment about whether to vote in favor or against the plan. After the disclosure statement is filed, a hearing must be held by the bankruptcy court to consider whether the disclosure statement should be approved. If the disclosure statement is approved, the debtor may then serve the plan and disclosure statement on its creditors and begin

[32] Surcharge actions may be brought under section 506(c) of the Bankruptcy Code.

soliciting acceptances of the plan. Likewise, plan opponents (such as a secured creditor or a creditors' committee dissatisfied with their respective treatments under the plan) may solicit rejections of the plan.

Under section 1126(c) of the Bankruptcy Code, an entire class of claims accepts a plan if the plan is accepted by creditors that hold at lease two-thirds in amount and more than one-half in number of the allowed claims in the class. Additionally, under section 1129(a)(10), if there are impaired class of claims, the bankruptcy court cannot confirm a plan unless the plan has been accepted by at least one class of non-insiders who hold impaired claims.[33] Any creditor or party in interest may file an objection to a plan. Irrespective of whether any objections to a plan have been filed, in order to confirm a plan, the bankruptcy court must be satisfied that the debtor has complied with all other requirements of confirmation pursuant to section 1129 of the Bankruptcy Code. Furthermore, the Bankruptcy Court must find that the plan is feasible, that it is proposed in good faith, that the plan proponent is in compliance with the Bankruptcy Code, and that confirmation of the plan is not likely to be followed by liquidation or further financial reorganization.[34]

Upon a bankruptcy court's confirmation of a plan, the debtor will receive a discharge.[35] The confirmation of a plan discharges the debtor from any debt that arose before the date of confirmation of the plan. After the plan is confirmed, the debtor must make all payments promulgated by the plan. Additionally, the debtor and all creditors and parties in interest are bound by the provisions of the plan, as a plan is essentially treated like a contract between

---

[33] Impaired claims are claims that are not going to be paid completely or in which some legal, equitable, or contractual right is altered.

[34] *See* section 1129 of the Bankruptcy Code.

[35] A discharge is not available in a Chapter 11 case for liquidating plans by non-individual debtors; *See* 11 U.S.C. §1141(d)(3).

parties. Accordingly, upon confirmation of a plan, creditors' legal rights are those specified in the plan.

B. Automatic Stay and Stay Relief

The filing of a petition for relief under the Bankruptcy Code results in the immediate imposition of the automatic stay. The imposition of the automatic stay is one of the most widespread and drastic effects of a bankruptcy filing. Section 362 of the Bankruptcy Code provides for a broad stay of litigation, lien enforcement and other actions, judicial or otherwise, which would effect or interfere with property of the debtor or property of the estate. As a general rule, if an action is something a creditor wants to do to collect a debt or enforce a lien, it is prohibited by the automatic stay.

The automatic stay, and the resulting injunction, applies to both real and personal property. Accordingly, any foreclosure sale on the debtor's property or property of the estate that occurs after the imposition of the automatic stay is a voidable transfer, and title to such property may be returned to the bankruptcy estate. A foreclosure sale after the commencement of a bankruptcy case may be avoided even when the sale was conducted in good faith and there was no actual notice of the bankruptcy and the existence of the automatic stay. Absent relief from the automatic stay, the continuation of a foreclosure proceeding with actual knowledge of the commencement of a bankruptcy case may subject the creditor to contempt sanctions.

Despite the fact that the automatic stay immediately halts a creditors' ability to enforce its rights to collect a debt or enforce a lien, the Bankruptcy Code affords a creditor the right to seek relief from the automatic stay. Section 362(d) of the Bankruptcy Code provides that the stay may be lifted upon a showing that the debtor does not have any equity in the property and the property is not necessary for an effective reorganization. If the debtor demonstrates that the property is necessary for an effective reorganization, the bankruptcy court may continue the stay.

However, in continuing the stay, the bankruptcy court may require the court to provide adequate protection to the creditor in order to protect the creditor against a decline in the value of its collateral. Adequate protection is a broad concept and can be provided in many forms, such as periodic cash payments to the creditor or granting the creditor a replacement lien on other property.

At any hearing on a motion for relief from stay, the Bankruptcy Code provides that the party seeking stay relief has the burden of proof on demonstrating the debtor's equity (or lack thereof) in the property, and the party opposing stay relief has the burden of proof on all other issues.

Although many creditors seek stay relief as soon as possible, the automatic stay eventually expires by operation of law. The automatic stay expires upon the occurrence of certain events. For example, the stay of a foreclosure action against property of the estate remains in place as long as the property remains property of the estate.[36] An example of when property no longer constitutes property of the estate is when such property is abandoned by the debtor or trustee.[37]

A trustee or debtor's abandonment of property is not the only way property would no longer constitute property of the estate. In the event a debtor or trustee sells estate property, such property is no longer property of the estate. Accordingly, if the property is subject to a lien, a creditor may enforce that lien when the sale becomes final. In this situation, the property would either be sold with the existing lien in place, or the property would be sold free and clear of the lien with the secured creditor receiving the proceeds from the sale necessary to satisfy the

---

[36] *See* 11 U.S.C. § 362(c)(1).

[37] A trustee or debtor may abandon property pursuant to Section 554 of the Bankruptcy Code when it is burdensome or is of no meaningful value to the estate.

indebtedness (or in an amount otherwise agreed by the parties).

In the event the automatic stay does not expire through the abandonment or sale of property, and is not lifted through litigation, the automatic stay remains in place until the case is either closed or dismissed.[38]

C. Reinstatement of Secured Debt

Although a debtor may file bankruptcy to avoid foreclosure, as described above, a debtor's options regarding the treatment of secured claims in bankruptcy cases are somewhat limited. In some bankruptcy cases, secured debt is reinstated. Sometimes the secured debt is reinstated without alteration to the original terms of the credit agreement. In other cases, the secured debt is reinstated with adjustments and modification to the original terms of the credit agreement. Secured debt can be reinstated in cases under Chapters 7, 11, or 13.

In a Chapter 7 case, the two most common ways in which secured debt can be reinstated is pursuant to a reaffirmation agreement or by "floating through" the bankruptcy case.[39] A debtor in Chapter 7 may seek to enter a reaffirmation agreement with the secured creditor. A reaffirmation agreement is a new contract between the debtor and a creditor under which the debtor agrees to pay a debt that would have otherwise been discharged. Reaffirmation is purely voluntary and the creditor is not obligated to enter into a reaffirmation agreement. However, in some cases, where there is a good business relationship and no existing defaults for example, a secured creditor may wish to enter a reaffirmation agreement to preserve the relationship with the debtor and/or avoid the transaction costs and fees associated with recovering the collateral.

---

[38] *See* 11 U.S.C. § 362(c)(2).

[39] An individual debtor in Chapter 7 may redeem tangible personal property intended primarily for personal, family, or household use, from a lien by paying the allowed amount of the secured claim in full. *See* 11 U.S.C. § 722. In order to redeem property from a lien in Chapter 7, the property must be exempt or have been abandoned from the bankruptcy estate. *Id.*

The Bankruptcy Code provides very specific and detailed requirements for reaffirmation agreements. Sections 524(c) and (d) of the Bankruptcy Code set forth the following requirements and conditions for reaffirmation agreements[40]:

a. The debt agreement is enforceable under nonbankruptcy law;

b. The reaffirmation agreement is made before the bankruptcy discharge is granted;

c. The agreement contains a clear and conspicuous statement which advises the debtor that the agreement may be rescinded at any time prior to discharge or within sixty days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the secured creditor;

d. The agreement contains a clear and conspicuous statement which advises the debtor that such agreement is not required under the Bankruptcy Code, under nonbankruptcy law, or under any agreement not in accordance with the provisions of the reaffirmation section of the Bankruptcy Code;

e. The agreement must be filed with the court and, if applicable, accompanied by a declaration or an affidavit of the attorney that represented the debtor during the course of negotiating the agreement, which states that:

    (i) the agreement represents a fully informed and voluntary agreement by the debtor;

    (ii) such agreement does not impose an undue hardship on the debtor or a dependent of the debtor; and

    (iii) the attorney fully advised the debtor of the legal effect and consequences of the agreement; and any default under such an agreement.

f. The debtor has not rescinded the agreement at any time prior to discharge or within sixty days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the secured creditor; and

g. In a case concerning an individual who was not represented by an attorney during the course of negotiating the agreement, the court approves such agreement as—

    (i) not imposing an undue hardship on the debtor or a dependent of the debtor; and

    (ii) in the best interest of the debtor.

[40] 11 U.S.C. § 524(c), (d).

h. In a case concerning an individual who is not represented by an attorney during the negotiation of the reaffirmation agreement, the Court must also hold a hearing at which the debtor is required to appear, and the Court informs the debtor that a reaffirmation agreement is not required under the Bankruptcy Code, or under non-bankruptcy law, and informs the debtor of the legal effects and consequences of entering into a reaffirmation agreement and of defaulting thereunder.

Although the Bankruptcy Code provides specific and detailed requirements and procedures regarding reaffirmation agreements, the process for obtaining approval of a reaffirmation agreement is not as complicated or burdensome as it may seem. Most bankruptcy attorneys have reaffirmation agreement forms that comply with the Bankruptcy Code requirements. Accordingly, reaffirmation agreements are not difficult to prepare and are not uncommon in Chapter 7 cases, especially in cases where the debtor is not in default and wants (or needs) to keep the secured creditor's collateral.

In some Chapter 7 cases, secured debt obligations simply "float through" without formally being administered by the Bankruptcy Court. This happens where a debtor simply continues to pay the secured creditor pursuant to the terms of the original debt agreement during the bankruptcy case. At first glance, it may appear that the "float through" is a better alternative than reaffirmation because it does not require going through all of the procedure requirements for approval of reaffirmation agreements. This is true; however, there are certain disadvantages to allowing a secured debt obligation to ride through the bankruptcy case.

As a preliminary matter, certain courts have indicated that "float through" is not an option for dealing with secured claims under the Bankruptcy Code, and the debtor only has three options for dealing with collateral: (i) surrender the collateral; (ii) redeem the collateral; or (iii) execute a reaffirmation agreement to retain the collateral.[41] Therefore, in certain jurisdictions debtors are compelled to formally deal with collateral pursuant to the options

[41] *See In re Johnson*, 89 F.3d 249 (5th Cir. 1996); *see also* 11 U.S.C. §521(2).

outlined in the Bankruptcy Code. Additionally, when a debtor in a Chapter 7 case receives a discharge, all of the debtor's personal liability under the secured debt agreement will be eliminated and the secured creditor is only protected by the surviving lien on the collateral.[42] In other words, the "float through" would effectively convert a recourse obligation into a non-recourse obligation where the secured creditor can only look to the collateral for recovery of the debt upon default.

As discussed above, in Chapter 11 cases, debtors can reinstate secured obligations pursuant to a plan of reorganization. In fact, a Chapter 11 plan can provide for curing or waiving existing defaults under the debt agreement and modify the repayment terms (except for claims secured by property that is the debtor's principal residence).[43] Even if a secured creditor does not agree to the proposed treatment of its claim in a Chapter 11 plan, the debtor can seek to "cramdown" the treatment of the secured creditor's claim in the plan by establishing that: (i) the plan provides that the secured creditor will retain the lien securing its claim; and (ii) the secured creditor will receive deferred cash payments totaling at least the amount of such creditor's allowed secured claim valued as of the effective date of the plan.[44] Thus, the reinstatement of secured debt in Chapter 11 proceedings is very similar to the reinstatement of secured debt obligations in Chapter 13 proceedings in that the plan must provide for the secured creditor to retain its lien to secure payment, the payment terms of claims secured by the debtor's principal residence cannot be modified, and the plan must provide for the payment of interest to compensate the secured creditor for having its claim paid over the duration of the plan.

---

[42] *See In re Belanger*, 962 F.2d 345 (4th Cir. 1992); 11 U.S.C. §524.

[43] 11 U.S.C. §§1123(a)(5)(A), (b)(5), (d).

[44] 11 U.S.C. § 1129(b)(2).

It is important to keep in mind that the reinstatement of secured debt obligations in a Chapter 11 plan of reorganization, or a Chapter 13 debt adjustment plan, only requires the debtor to pay the creditor's "allowed" secured claim. Under the Bankruptcy Code, a secured claim is only "allowed" to the extent of the value of the collateral securing the claim as of the bankruptcy filing date.[45] In other words, for the purposes of determining how much a debtor is obligated to pay for a secured claim under a Chapter 11 or Chapter 13 plan, the allowed secured claim is only equal to the value of the collateral securing the claim and any deficiency is an unsecured claim.[46] To the extent a secured creditor is undersecured, its claim is split into a secured claim allowed in the amount of the value of the collateral and a general unsecured claim for the balance of the debt. The requirements for the payment in full of secured claims in Chapter 11 and Chapter 13 only apply to the "allowed" amount of secured claims. Unsecured deficiency claims are only entitled to the treatment provided to all other general unsecured claims under the plan.

D. Avoidance Issues

A Trustee, or debtor-in-possession in a Chapter 11 case, is entitled to seek the avoidance and recovery of certain transfers that occur within certain time periods prior to the bankruptcy filing. Specifically, the fraudulent transfer provisions of the Bankruptcy Code provide that a Trustee may avoid any transfer of the debtor's property that was made within one year before the filing of the bankruptcy petition, if the debtor received less than reasonably equivalent value in exchange for the property and was insolvent on the date the transfer was made (or became insolvent as a result of the transfer).[47] Under the Bankruptcy Code, a foreclosure sale is

---

[45] 11 U.S.C. § 506(a).

[46] *Id.*

[47] 11 U.S.C. §548(a).

expressly defined as a "transfer."[48] Accordingly, a foreclosure sale that occurs within a year of the debtor's bankruptcy filing could be susceptible to an avoidance suit.

Prior to 1994, there were discrepancies among various courts in different jurisdictions regarding whether a low price received pursuant to a foreclosure sale could be considered "less than reasonably equivalent value" under the Bankruptcy Code's fraudulent transfer provisions. Some Courts adopted the approach outlined in *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (5th Cir. 1980). In *Durrett*, the Court held that a foreclosure sale for less than fair market value was fraudulent.[49] The Court also suggested that a foreclosure sale price of seventy percent (70%) of fair market value was the minimum acceptable price to shield the sale from avoidance.[50]

Other courts followed the approach outlined in *In re Madrid*, 21 B.R. 424 (9th Cir. B.A.P. 1982). The court in *Madrid* held that the foreclosure sale was not a fraudulent transfer of the debtor's property where the foreclosure sale price was well below market value, because the foreclosure sale was lawfully conducted pursuant to the applicable state law requirements and was noncollusive.[51] Accordingly, under the *Madrid* approach, as long as a foreclosure sale is conducted honestly and pursuant to applicable state foreclosure law requirements, the foreclosure sale price is presumed adequate.

In 1994, the Supreme Court resolved the split among the Courts regarding the issue related to the adequacy of a foreclosure sale price for fraudulent transfer purposes. In *BFP v. Resolution Trust Cop.*, 114 S.Ct. 1757 (1994), the Supreme Court followed an approach similar

---

[48] 11 U.S.C. §101(54).

[49] *Durrett v. Washington National Insurance Co.,* 621 F.2d 201, 204 (5th Cir. 1980).

[50] *Id.* at 203.

[51] *In re Madrid*, 21 B.R. 424, 427 (9th Cir. B.A.P. 1982).

to the one adopted in *Madrid*. The Supreme Court held that as long as a foreclosure sale is conducted in compliance with applicable state law, the sale price is deemed to be "reasonably equivalent value" for the property.[52] The Court stated that since distress asset sales rarely result in market sale prices, the Bankruptcy Code's fraudulent transfer provisions could not be intended to allow courts to apply a fair market value standard to the price received at foreclosure sale.[53]

The Court also reasoned that its conclusion is supported by the express language of the Bankruptcy Code's fraudulent transfer statute which provides that "reasonably equivalent value" must be provided in exchange for the debtor's property, not "fair market value."[54] Consequently, as long as a foreclosure sale is conducted in accordance with applicable state foreclosure law, the sale is not subject to avoidance by the Trustee, regardless of the foreclosure sale price.

Dallas_1\4051543\15
999997-1 11/22/2004

---

[52] *BFP v. Resolution Trust Corp.*, 114 S.Ct. 1757, 1765 (1994).

[53] *Id.* at 1767.

[54] *Id.* at 1765.