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SECURED CREDITORS AND CONSUMER BANKRUPTCY IN THE UNITED STATES[©]

BY WILLIAM C. WHITFORD*

This article first summarizes the many restrictions that the American consumer bankruptcy system imposes on the enforcement of the contractual rights of secured creditors. The restrictions include the ability, in Chapter 13 proceedings particularly, of the debtor to “strip the lien” of the undersecured creditor, releasing the collateral from the lien upon payment, over time, of only the value of the collateral when it is less than the full amount owing. The article then summarizes many changes in the rights of secured creditors currently being proposed and debated in Congress. The author concludes with his own proposals that would enhance the rights of secured creditors, and make lien stripping less available in American bankruptcy proceedings.

Cet article résume d’abord les restrictions multiples que le système américain de la faillite impose sur les droits contractuels des créanciers garantis. Les restrictions comprennent le pouvoir, particulièrement dans les procédures du Chapitre 13, pour le débiteur d’ôter le droit de gage des créanciers sousgarantis, libérant ainsi le collatéral du privilège de gage après paiement, en temps supplémentaire, de la valeur du collatéral seulement quand elle est inférieure au total du montant dû. L’article résume ensuite plusieurs changements dans les droits des créanciers garantis actuellement proposés et débattus au Congrès. L’auteur conclut par ses propres propositions qui augmenteraient les droits des créanciers garantis, et rendraient le fait d’ôter le droit de gage moins disponible dans les procédures américaines sur la faillite.

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I. INTRODUCTION

In Part II of this article, I provide an overview of American law respecting the rights of secured creditors in consumer bankruptcy. I will focus on the main principles, frequently omitting discussion of nuanced exceptions or of conflicts between jurisdictions on detailed points. In Part III, I describe the principal changes in the rights of secured creditors recommended by the National Bankruptcy Review Commission (NBRC), and provided in several different proposals presently being considered by the United States Congress. In Part IV, I offer my comments on a number of policy issues raised by these legislative proposals, focusing particularly on the rights of undersecured creditors in consumer bankruptcy. My major contention is that, as a matter of policy, current American law is in some respects insufficiently protective of the undersecured creditor's interests.

II. THE STATUS OF SECURED CREDITORS IN CONSUMER BANKRUPTCY

This Part is divided into four sections dealing with (1) the validity of security interests in bankruptcy; (2) when a claim is considered in default in bankruptcy; (3) modifying the rights of the oversecured creditor; and (4) modifying the rights of the undersecured creditor. The

discussion presumes an understanding of the basic principles of American consumer bankruptcy law, including an understanding of the basic features of Chapters 7 and 13, the two bankruptcy procedures usually selected by consumer debtors.¹

A. *Validity of Security Interests in Bankruptcy*

In general, bankruptcy law defers to non-bankruptcy law (primarily state law) for determining the validity of claims and their relative priority, and this principle applies to determining the status of claims as secured. The most important exceptions relevant to consumer bankruptcy are provided in section 522(f)(1) of the United States *Bankruptcy Code*,² which invalidates—in two distinct situations—a security interest if it “impairs” an exemption.³ It is standard non-bankruptcy law that exemptions do not prevent seizure of exempt assets by a creditor with a security interest in them, but exemptions do protect assets from seizure by unsecured creditors, and hence by their representative in bankruptcy, the bankruptcy trustee. So when section 522(f)(1) invalidates a security interest in exempt assets, rendering the previously secured creditor’s claim unsecured, it effectively increases the exempt assets that the debtor will be able to retain after filing bankruptcy.

Section 522(f)(1)(A) invalidates a security interest that impairs an exemption when the security interest is a judicial lien. A judicial lien is a security interest that arises by a judicial process;⁴ the term does not include consensual and statutory liens. Normally, judicial liens do not arise in exempt property, since the principal function of exemptions outside of bankruptcy is to protect assets from becoming collateral for a debt by judicial process. However, sometimes a debtor’s exemptions are

¹ For an excellent general discussion of American bankruptcy law, see C.J. Tabb, *The Law of Bankruptcy* (Westbury, N.Y.: Foundation Press, 1997). For descriptions of the reasons that a consumer debtor might select Chapter 13 rather than Chapter 7, see authorities cited in note 69, *infra*.

² 11 U.S.C. § 522(f)(1) (1998) [hereinafter *Bankruptcy Code*].

³ Only individual debtors are entitled to exemptions in bankruptcy: see *ibid.* § 522(b). Accordingly, the provisions here discussed have relevance primarily in consumer bankruptcy. The debtor in a business bankruptcy is normally a corporation. There is a considerable amount of detailed law about what it means to “impair” an exemption that will not be discussed herein: see *ibid.* § 522(f)(2).

⁴ The term “judicial lien” is defined in section 101(36), *ibid.*

greater in bankruptcy than they were before filing.⁵ If the collateral was non-exempt before bankruptcy, it could be attached by a judicial lien. When the collateral becomes exempt in bankruptcy, section 522(f)(1)(A) invalidates the judicial lien. This has the effect of extending backwards in time the expanded bankruptcy exemptions to invalidate judicial liens that could never have come into existence if the assets were recognized as exempt at the time of the legal proceedings creating the judicial lien.

Section 522(f)(1)(B) invalidates non-possessory, nonpurchase-money security interests—no matter how created (*i.e.*, judicially, consensually, or by statute)—if the security interest impairs an exemption, and the collateral belongs to the category of either (1) household furnishings, musical instruments, jewellery, professionally prescribed health aids, and a few other assets held primarily for personal use; or (2) professional books and tools of the trade. The vast majority of security interests in personalty owned by consumers are purchase money security interests, and are unaffected by this provision. The provision did have an impact on a lending pattern that was commercially significant in 1978 when it was enacted. In some instances, a lender took a security interest in a large number of the debtor's previously acquired personal possessions, sometimes called a "blanket security interest." Such security interests allowed the lender to threaten the debtor with repossession of large amounts of the debtor's possessions. Even if these possessions had little resale value, such threats could be effective in inducing the debtor to make payments—even after a bankruptcy filing—to avoid repossession. The frequency of this lending practice has declined considerably, partly because the security agreements are unenforceable in bankruptcy, but also because, in 1984, the Federal Trade Commission prohibited, as "unfair," nonpossessory, nonpurchase-money security interests in a somewhat narrower range of assets than is covered by section 522(f)(1)(B).⁶

⁵ The *Bankruptcy Code* allows each state to decide either (1) to restrict its domiciliaries who file bankruptcy to the exemptions allowed under state law to non-bankrupts, or (2) to allow its domiciliaries to elect in bankruptcy between state exemptions and a list of "federal" exemptions provided in the *Bankruptcy Code* itself: see *ibid.* § 522(d). Approximately a dozen jurisdictions have selected the second option. In those jurisdictions, some debtors will elect the federal exemptions because, in their particular circumstance, the federal exemptions are more generous than the alternative state exemptions.

⁶ *FTC Credit Practices Rule*, 16 C.F.R. § 444.2(a)(4) (1999). The Federal Trade Commission (FTC) rule applies just to security interests in "household goods," which are defined rather narrowly and specifically exclude jewellery: see *ibid.* § 444.1(i). For a discussion of this rule, see R.E. Scott, "Rethinking the Regulation of Coercive Creditor Remedies" (1989) 89 *Colum. L. Rev.* 730 [hereinafter "Coercive Creditor Remedies"]; and W.C. Whitford, "The Appropriate Role of Security Interests in Consumer Transactions" (1986) 7 *Cardozo L. Rev.* 959 at 985-92 [hereinafter

B. Bankruptcy as Default

In consumer bankruptcy, very commonly the debtor's payments on secured claims are in arrears at filing, in which case the loan is in default, and the secured creditor's rights in bankruptcy will depend on whether the creditor is oversecured or undersecured. Those rights are outlined below. In some instances, however, at the time of filing, the debtor is current in his or her payments on one or more secured claims—*e.g.*, on an automobile or home mortgage debt. There currently is a split of authority among the United States courts of appeals about whether such a secured obligation will be treated as a defaulted obligation within bankruptcy if it is not in default under non-bankruptcy law. If the secured obligation is considered not to be in default, then the secured obligation is said to “ride through” bankruptcy, with the creditor unable to repossess the collateral so long as the debtor maintains payments. Since a discharge will usually end the debtor's personal liability on the debt, the secured creditor's sole remedy if the debtor then stops making payments will be repossession of the collateral.

This article is not the appropriate place for a detailed analysis of the legal issues under litigation, which have been well canvassed elsewhere.⁷ Much of the debate centres on the interpretation of a section of the *Bankruptcy Code* that requires a debtor to state his or her intentions with respect to collateral securing a consumer debt within a short period of time after filing.⁸

C. Modifying the Rights of the Oversecured Creditor

The oversecured creditor is a creditor owed less than the value of its collateral at the time of filing. In this discussion, I will assume that the loan is considered in default. I divide the various modifications of a

“The Appropriate Role of Security Interests”].

⁷ See, for example, L. Ponoroff, “Surf's Up, Dude: Riding Through Bankruptcy” (1998) 7 J. Bankr. L. & Prac. 101; and R.H. Nowka, “Validating a Debtor's Retention of Collateral by Continuing Performance: Removing the Obstructions of 11 U.S.C. § 521(2)(A) and *Ipsa Facto* Clauses” (1997) 6 J. Bankr. L. & Prac. 145.

⁸ See *Bankruptcy Code*, *supra* note 2, § 521(2). The section lists just three options for the debtor's statement of intentions: surrender of collateral, redemption pursuant to section 722, or reaffirmation. Since simple maintenance of payments of obligations not in default is not one of the options mentioned, some courts have interpreted the section as excluding that option, requiring the debtor to choose one of the specified options: see, for example, *In re Edwards*, 901 F.2d 1383 (7th Cir. 1990). The effect of such decisions is to limit the debtor's options to those that would have been available if payments had been in default at the time of filing.

secured creditor's rights made by bankruptcy into two categories: (1) restrictions on special enforcement rights to which the secured creditor is entitled by non-bankruptcy law—such as the right to replevin or repossession, or to private sale of the collateral; and (2) modification of the secured creditor's priority rights, *vis-à-vis* other creditors, in the wealth represented by the collateral.

1. Enforcement rights

The oversecured creditor's enforcement rights with respect to the collateral are greatly restricted. Where the creditor is oversecured, the excess collateral value belongs either to the debtor, when exempt, or to the bankruptcy estate (as a fiduciary for unsecured creditors) when not exempt. When the excess collateral value belongs to the bankruptcy estate, it is a fundamental principle of American bankruptcy law that the estate controls disposition and use of the entire collateral. Before bankruptcy, a secured creditor, upon default, has special rights to promptly seize the collateral and put it up for sale. Even though unsecured creditors have an interest in the excess collateral value, their rights to control the manner of the sale of the collateral are quite limited. In bankruptcy, however, it is established that the trustee, as a representative of the unsecured creditors, controls disposition and use of the collateral, in order to maximize the sale proceeds and thereby subsequent distributions to unsecured creditors.

Remarkably, significant restrictions on a secured creditor's enforcement rights also exist when the excess collateral value belongs to the debtor, as exempt property. The automatic stay in bankruptcy prevents repossession of the collateral by the secured creditor throughout the proceeding,⁹ providing that the secured creditor's interest in the collateral is "adequately protected."¹⁰ What constitutes "adequate protection" is a topic far too detailed for full treatment here, but where the secured creditor is oversecured, the excess collateral value

⁹ Technically, the excess value remains the property of the estate until the trustee "abandons" the property, on the ground that there is no value in it for the estate: see *Bankruptcy Code*, *supra* note 2, § 554. The automatic stay terminates with respect to property of the estate once it no longer belongs to the estate: *ibid.* § 362(c)(1). However, section 362(a)(5) still prevents enforcement of a lien against property of the debtor. Where the creditor is oversecured, the creditor cannot obtain relief from the stay pursuant to section 362(d)(2), since the debtor has equity in the collateral.

¹⁰ A secured creditor can always obtain relief from the automatic stay when its interest in the collateral is not adequately protected: see *ibid.* § 362(d)(1). The term "adequate protection" is defined, with considerable vagueness, in section 361.

(called the “equity cushion”) will commonly be considered sufficient to adequately protect the creditor against reasonably foreseeable declines in the value of the collateral. The condition of adequate protection will normally require that the debtor maintain sufficient insurance against theft of the collateral, or sudden destruction by accident or other calamity.

With respect to exempt property, the automatic stay terminates when the debtor is granted a discharge or the bankruptcy proceedings are dismissed, and the creditor can resort to whatever enforcement rights state law grants. In a Chapter 7 consumer bankruptcy, discharge will occur normally within three to six months of filing, with the typical time period varying by judicial district.

The ability to protect against repossession through the automatic stay, even though the bankruptcy estate has no interest in the collateral, has led to repeat debtor filings as a strategy to avoid foreclosure on collateral. Under this strategy, a debtor files, gains the benefit of an automatic stay, and then dismisses the proceeding before the granting of a Chapter 7 discharge.¹¹ After dismissal, a secured creditor may renew the foreclosure proceedings in state court, but the debtor can then refile bankruptcy and the process is then repeated. There is no specific statutory prohibition against refiling, or limitation of the automatic stay when the debtor has previously filed.¹²

2. Priority rights

The oversecured creditor’s priority rights are well protected in Chapter 7. If the collateral is sold by the Chapter 7 trustee during the bankruptcy proceeding, the secured creditor will have first claim on the proceeds, and that claim will include interest at the contract rate for the period after bankruptcy filing (called “pendency interest”¹³). If the

¹¹ A Chapter 7 discharge triggers a six-year period in which another discharge cannot be granted: see *ibid.* § 727(a)(8). Since a discharge does not affect the secured creditor’s claim to the collateral, a debtor concerned solely with avoiding foreclosure would prefer not to get a discharge and the associated six-year bar on subsequent discharges.

¹² It is difficult to know how frequently the practice occurs. Not all repeat debtor filings are motivated solely by the desire to prevent foreclosure by a secured creditor. A similar strategy is sometimes pursued to avoid eviction under a lease, since the automatic stay also prevents continuation of a pending eviction proceeding.

¹³ There is no conclusive authority that the pendency interest will be allowed at the contract rate, but that is the usual result: see *Key Bank National Association v. Milham*, 141 F.3d 420 (2d Cir. 1998) at 423 [hereinafter *Key Bank*]; and Tabb, *supra* note 1 at 555.

collateral is not sold during the Chapter 7 proceeding—most likely because the excess value was exempt—then the automatic stay terminates upon the completion of the Chapter 7 proceeding. The secured creditor can collect pendency interest for the entire period between bankruptcy filing and discharge, and is entitled to its full non-bankruptcy enforcement and priority rights with respect to the collateral.

The oversecured creditor's priority rights are not nearly as well protected in Chapter 13. If a confirmed Chapter 13 plan entitles the debtor to retain the collateral (as is usual), the oversecured creditor must be paid its claim in full, together with interest from the date of filing. However, interest after confirmation of the plan¹⁴ will be paid at a rate set by the court, and the standards for setting that rate vary around the country. Some courts estimate a market rate at which loans of this type are normally made, and use the contract rate as presumptive evidence of that rate.¹⁵ Other courts use different benchmarks, and usually arrive at interest rates that are less than the contract rate.¹⁶ Furthermore, the plan can modify the period of payment, reducing the monthly amounts and extending the loan over the period of the Chapter 13 plan.¹⁷

¹⁴ Confirmation of the plan usually occurs between 60 and 120 days after filing, the precise period varying by judicial district. Interest for the period between filing and confirmation should be paid at the contract rate, since it is pendency interest. I am not aware of any empirical studies showing whether Chapter 13 trustees observe this technical point. I would not be surprised if, in many parts of the country, the court-set rate for interest were used from the date of bankruptcy filing.

¹⁵ See *Green Tree Financial Services Corp. v. Smithwick*, 121 F.3d 211 (5th Cir. 1997); and *GMAC v. Jones*, 999 F.2d 63 (3d Cir. 1993).

¹⁶ See *Key Bank*, *supra* note 13; and *United States v. Doud*, 869 F.2d 1144 (8th Cir. 1989). For a good discussion of the case law as of 1995, see D. Pawlowic, "Entitlement to Interest Under the Bankruptcy Code" (1995) 12 *Bankr. Dev. J.* 149 at 173-78.

¹⁷ The majority of Chapter 13 plans are not completed. Of the failed plans, a small percentage are converted to Chapter 7 and the balance are dismissed: see E. Warren, "A Principled Approach to Consumer Bankruptcy" (1997) 71 *Am. Bankr. L.J.* 483 at 495, n. 25. (The Administrative Office of United States Courts estimates that 36 per cent of Chapter 13 cases result in a discharge, 49 per cent are dismissed without a discharge, and 14 per cent are converted to Chapter 7.) When a Chapter 13 proceeding is dismissed, the automatic stay terminates and the secured creditor can look to its collateral for payment of any amount not paid through the plan, including interest at the contract rate from the time of bankruptcy filing. During the period of a Chapter 13 plan, the creditor's rights in the collateral must be adequately protected, for fear the plan will fail and the creditor will not be paid in full under the plan. However, the equity cushion normally provides sufficient adequate protection, providing the debtor maintains adequate insurance on the collateral.

There is room for debate about what should be considered the proper measure of a creditor's priority rights with respect to interest.¹⁸ However, the contract rate is usually deemed the appropriate rate for pendency interest in Chapter 7, and there is no reason in policy to distinguish interest paid in Chapter 13, since, there also, the automatic stay (and/or the confirmed Chapter 13 plan) prevents repossession of the collateral by the secured creditor. In both cases, the issue is what interest should be paid for what is, in effect, a forced loan by the secured creditor. If the contract rate is considered the proper measure for protecting the oversecured creditor's priority rights, the Chapter 13 rules providing for a lower rate, paid over a longer period of time than contracted for, can be seen as a significant restriction of those rights. At least in theory, the savings are passed on to unsecured creditors, who should receive higher payments than they would if secured creditors' priority rights were respected in the Chapter 13 plan.¹⁹

There are two important exceptions to the general rules governing the priority rights of oversecured creditors in Chapter 13. Where the collateral is the debtor's principal residence, the plan may not reduce the interest rate or the size of the monthly payments from the contract rate, nor may it extend the period of final payment.²⁰ However, for any debt for which the final payment is not due during the period of the plan (usually three years), the plan can provide for maintenance of payments at the contract rate during the plan, and additional payment for any arrears owing at the time of filing. If such a plan is satisfactorily

¹⁸ What the secured creditor loses when it cannot foreclose is the opportunity to use the proceeds from repossession (for the oversecured creditor, the full amount owing) for other purposes. If foreclosure is prevented by the automatic stay, proper respect for the creditor's priority rights would seem to require reimbursement for these lost opportunities. The contract rate is often a good estimate of what the secured creditor could have earned by reinvesting the money in another consumer loan, though, of course, market rates may have changed since the loan in question was originated. On the other hand, if the secured creditor has ready access to additional capital (perhaps through bank borrowing), then the proper measure of the opportunity cost is the cost of additional capital to the secured creditor. In that circumstance, preventing foreclosure does not prevent the creditor from making additional investments, but only requires it to obtain the capital in another way.

¹⁹ A debtor is supposed to devote all disposable earnings for a period of three years to payments under a Chapter 13 plan, as a condition on confirmation of the plan: see *Bankruptcy Code*, *supra* note 2, § 1325(b)(1)(B). Hence reduced payments to secured creditors should not result in reduced payments into the plan by the debtor.

²⁰ See *ibid.* § 1322(b)(2). Because the section prohibits modification of the security interest if the collateral is "only ... the debtor's principal residence," there has been litigation, with varying results, about whether the anti-modification rule applies to real estate mortgages that cover fixtures or other personalty normally associated with a residence: compare *In re Hammond*, 27 F.3d 52 (3d Cir. 1994) with *In re Davis*, 989 F.2d 208 (6th Cir. 1993).

completed, the debt will be considered as no longer in default.²¹ The creditor will retain its security interest in the collateral, but it may not resort to enforcement rights until there is a further default after completion of the Chapter 13 plan. Because most real estate mortgages are long-term debts not fully payable within three or five years of filing, they are usually provided for in this manner by a Chapter 13 plan.

D. *Modifying the Rights of the Undersecured Creditor*

An undersecured creditor's claim exceeds the value of its collateral. It is a fundamental principle of American bankruptcy law (called "bifurcation") that an undersecured creditor has two claims—a secured claim to the extent of the value of its collateral, and an unsecured claim for the balance, sometimes called the deficiency. Bifurcation requires valuation of the collateral to determine the size of each of the creditor's two claims. Where the collateral is liquidated during the bankruptcy proceeding, the amount received from the liquidation normally sets the value of the secured claim. Where the debtor retains the collateral, however, valuation is a very difficult issue. A recent United States Supreme Court decision has held that the standard of valuation where the debtor keeps the collateral is not what the collateral would yield for the creditor if liquidated, but rather its "replacement value"—the amount "a willing buyer in the debtor's ... situation would pay to a willing seller to obtain property of like age and condition."²² Because the property retained by the debtor has been used and is normally not covered by any warranty rights in the event of malfunction, it is often difficult to find real world transactions in which a willing buyer is acquiring anything closely resembling the collateral retained by the debtor. Nonetheless, the court must imagine such a transaction in determining the value of the collateral.²³

²¹ See *Bankruptcy Code*, *supra* note 2, § 1322(b)(5).

²² *Associates Commercial Corp. v. Rash*, 520 U.S. 953 at 959 (1997) [hereinafter *Rash*]. This case concerned valuation of collateral retained by the debtor in a Chapter 13 proceeding, but the rationale of the opinion would seem to require application of the same standard when it is necessary to value collateral retained by the debtor in a Chapter 7 case—*e.g.*, when the debtor redeems collateral pursuant to section 722 of the *Bankruptcy Code*, *supra* note 2.

²³ The United States Supreme Court anticipated this valuation difficulty, and left to the bankruptcy courts, as triers of fact, the task of "[identifying] ... the best way of ascertaining replacement value on the basis of the evidence presented": *Rash*, *supra* note 22 at 963-965, n. 6. David Carlson perceptively characterizes this type of "fact" as a "subjunctive fact," because it requires the court to find as a fact what would have happened if the world were different (*i.e.*, the

Except as this valuation discussion bears on the size of the unsecured claim, my discussion in this section is limited to the undersecured creditor's secured claim. As in the preceding section, I will assume that the loan is considered in default. I will divide my discussion between (1) restrictions on the creditor's special enforcement rights, and (2) modifications of the creditor's priority rights in the collateral.

1. Enforcement rights

The undersecured creditor's enforcement rights in Chapter 7 are more extensive than an oversecured creditor's enforcement rights. An undersecured creditor is entitled to relief from the automatic stay, enabling it to foreclose upon and sell the collateral during the pendency of the Chapter 7 proceeding.²⁴ However, relief from the stay requires a motion and order of the court, with the attendant delay and legal costs. It is more common, therefore, for the undersecured creditor to wait for the granting of a discharge—which generally occurs three to six months after filing—when the automatic stay terminates with respect to property in which the estate has no interest.²⁵

A debtor who wishes to retain the collateral in the face of the creditor's enforcement rights can redeem the collateral free from the security interest, or reach an agreement with the creditor not to foreclose. Redemption is generally difficult and rare in practice. Under non-bankruptcy law, usually the debtor must repay the entire amount owing, including the deficiency.²⁶ The *Bankruptcy Code* provides a Chapter 7 debtor a special right to redeem collateral from the security interest upon payment of the collateral's value, at the time of filing, providing the collateral is tangible personalty held primarily for personal

debtor was purchasing the collateral instead of retaining it), when we know that the world will not be different: see D.G. Carlson, "Secured Creditors and the Eely Character of Bankruptcy Valuations" (1991) 41 Am. U. L. Rev. 63 at 70-75. For an insightful effort to make practical sense of the United States Supreme Court's "replacement value" standard, see J. Braucher, "Getting It for You Wholesale: Making Sense of Bankruptcy Valuation of Collateral After *Rash*" (1998) 102 Dick. L. Rev. 763.

²⁴ See *Bankruptcy Code*, *supra* note 2, § 362(d)(2).

²⁵ *Ibid.* § 362(c)(2)(c). When the creditor is undersecured, it follows that the estate has no interest in the collateral.

²⁶ At one time, it was thought that section 506(d) of the *Bankruptcy Code*, *supra* note 2, changed this usual state law rule by declaring invalid a lien to the extent the amount owing exceeded the value of the collateral. However, the United States Supreme Court rejected this view in *Dewsnup v. Timm*, 502 U.S. 410 (1992).

or household use.²⁷ However, this amount must be paid all at once, which makes redemption rare in practice, unless the value of the collateral is low, because consumer debtors do not usually have access to the resources needed to make large lump-sum payments.

Reaching an agreement with the creditor not to foreclose, on the other hand, is very common. The creditor normally requires, as a condition of agreeing to forego repossession, that the debtor "reaffirm" the debt. In practice, most creditors insist on an agreement to pay the full amount owing, including the deficiency and pendency interest, but they permit this amount to be paid over time in reasonable monthly payments, rather than in a lump sum. The latter concession is what makes reaffirmations more attractive and practical to debtors than redemptions, even though by reaffirming, the debtor, in effect, waives his or her discharge with respect to the deficiency.²⁸ Creditors in turn prefer reaffirmations to foreclosure, because the promise of payment of the full amount owing, albeit over time, is worth more than foreclosure of collateral that will yield substantially less. Reaffirmations must be filed with the bankruptcy court, but they are permissible without specific court approval if the agreement is reached before a discharge is granted.²⁹

As an alternative to redemption or reaffirmation, a debtor seeking to retain collateral who is able to avoid creditor efforts to obtain pre-discharge relief from the automatic stay, can sometimes file a Chapter 13 proceeding immediately after the granting of a Chapter 7 discharge. The purpose of refiling is to reinstate the automatic stay. This is the so-called Chapter 20. Pursuant to a United States Supreme Court decision specifically on point, the second filing (*i.e.*, the Chapter 13

²⁷ See *Bankruptcy Code*, *supra* note 2, § 722. The bankruptcy estate must also have no interest in the collateral, which will always be the case when the creditor is undersecured.

²⁸ For the reasons why a debtor would ever be willing to pay more than the value of the collateral to avoid foreclosure, see notes 34-35, *infra*, and accompanying text. Essentially, the point is that the use value to the debtor is higher than its market or resale value.

²⁹ See *Bankruptcy Code*, *supra* note 2, § 524(c). The section establishes other preconditions to the validity of reaffirmation agreements not mentioned in the text, including (1) provision and notice to the debtor of a sixty-day rescission period, and (2) the filing of an affidavit by the debtor's attorney that the agreement does not impose an undue hardship on the debtor or his or her family. The debtor is normally represented by an attorney at the time of the reaffirmation agreement, since it must be entered into before the granting of a discharge, and debtors' attorneys usually actively represent the debtor until that moment. If the debtor is not represented at the time of a reaffirmation agreement, the court must hold a hearing and make a finding that the reaffirmation is in the best interest of the debtor, unless the collateral is real property.

filing) is permitted if it is in “good faith.”³⁰ In a successful Chapter 20, the unsecured claims will for the most part be discharged in the Chapter 7 proceeding, including the unsecured portion (*i.e.*, the deficiency) of the undersecured creditor’s claim. The undersecured creditor’s secured claim, which survives the Chapter 7 proceeding intact, will be dealt with in accordance with Chapter 13 rules discussed next.

In Chapter 13, an undersecured creditor will not normally be entitled to relief from the automatic stay.³¹ The secured creditor is entitled to adequate protection, which normally is provided by payments under the plan and, depending on the collateral, may also require the debtor to maintain insurance against loss to the collateral by theft or accident. About two-thirds of Chapter 13 plans are not successfully completed.³² Usually the bankruptcy proceeding is dismissed upon failure of the plan, in which event the automatic stay terminates, but, in some instances, the case is converted into a Chapter 7 proceeding and the rules discussed above apply.³³

2. Priority rights

Before describing to what extent an undersecured creditor’s priority rights are compromised in Chapters 7 and 13, it is useful to address generally the troublesome issue of lien stripping. Until bankruptcy is filed, upon default, an undersecured creditor can foreclose on the collateral unless the entire amount owing is paid, even though the amount owing exceeds the value of the collateral. A debtor often places greater value on collateral than its market or resale value. (Henceforth I will use the term “hostage value” to refer to the difference between the

³⁰ See *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

³¹ The court should grant relief from the automatic stay in favour of the undersecured creditor if the collateral is not essential to a successful reorganization: see *Bankruptcy Code*, *supra* note 2, § 362(d)(2). This conclusion is rarely reached in consumer cases with respect to residences, motor vehicles, or household possessions, the items that normally constitute collateral.

³² See note 17, *supra*. In a very small percentage of Chapter 13 proceedings, the debtor does not succeed in getting a Chapter 13 plan confirmed. When that happens, the consequences are similar to plan failure.

³³ If the creditor’s secured claim is paid in full before dismissal or conversion, in most districts the security interest is deemed satisfied, even though the creditor’s deficiency claim is unpaid: see note 41, *infra*, and accompanying text.

use value of the collateral to the debtor and its market or resale value.³⁴) A debtor often has some idiosyncratic use for, or an emotional attachment to, the collateral. Furthermore, in assessing the value of avoiding foreclosure, the debtor must take into account the transaction costs of replacing the collateral. For these reasons, a well informed and rational debtor is often willing to pay the entire amount owing to avoid foreclosure, even though that amount considerably exceeds the collateral's resale or market value.³⁵ Because undersecured creditors frequently have great difficulty in collecting deficiency judgments from debtors after foreclosure and resale of collateral, the ability to induce payment of the entire amount owing by threatening foreclosure unless that amount is paid is very valuable to the creditor.³⁶

In bankruptcy, principally in Chapter 13, it is sometimes possible for the debtor to "strip the lien" of an undersecured creditor—that is, to obtain release of the lien without the creditor's consent by paying the value of the collateral as of the date of filing. Such a result protects the creditor's priority claim to the value of the collateral, and it gives the creditor at least as much as it would receive if foreclosure and resale occurred. But this result deprives the undersecured creditor of its ability outside bankruptcy to threaten foreclosure unless the entire amount owing is paid, a bargaining leverage that commonly yields a reaffirmation for the full amount owing for the reasons just explained. Consequently, if a debtor is able to "strip a lien" in bankruptcy, the economic value of an undersecured creditor's pre-bankruptcy legal rights have been significantly compromised.

Chapter 7 debtors can rarely strip the lien held by an undersecured creditor. Debtors are entitled to redeem collateral that is

³⁴ Robert Scott should get credit for inventing the term "hostage value" to refer to the difference between the debtor's use value and the market value of the consumer goods: see "Coercive Creditor Remedies," *supra* note 6 at 746-49, which discusses the use of hostages as a way to make promises to pay credible, and analogizes the granting of security interests in consumer goods to the giving of hostages.

³⁵ For a fuller account of the thesis that collateral frequently has higher use value to the debtor than its market value, see "The Appropriate Role of Security Interests," *supra* note 6 at 961-62, and authorities cited therein (including especially Arthur Leff, to whom I am indebted for many of these ideas).

³⁶ Though the debtor is frequently legally liable for the deficiency under non-bankruptcy law, in practice, undersecured creditors lending to consumers rarely pursue or collect a deficiency after foreclosure. One might expect that savvy debtors would use this fact to bargain with undersecured creditors to accept less than the full amount owing, which can still be more than the creditor would net from foreclosure. For an explanation of why it is rational for most creditors to hold out for the full amount owing and to foreclose unless they get it, even though deficiencies are difficult to collect, see "The Appropriate Role of Security Interests," *supra* note 6 at 963-65.

tangible personalty from a lien upon payment of collateral value at the time of filing, but debtors rarely exercise this option because it requires a lump-sum payment at a time when they do not have such cash resources. Debtors much more frequently reaffirm their debt for the full amount owing in order to avoid repossession.³⁷ In Chapter 7, an undersecured creditor need not be paid pendency interest, even on the creditor's secured claim.³⁸ However, in Chapter 7 cases the undersecured creditor can generally obtain relief from the automatic stay within a few months. If the creditor does not then foreclose, it is usually because it has entered into a reaffirmation agreement with the debtor providing for interest payments at a rate negotiated by the creditor, and usually covering the pendency period. Hence the denial of pendency interest is relatively unimportant in Chapter 7 consumer cases. In sum, an undersecured creditor's priority rights are normally well protected in Chapter 7.

The situation is quite different in Chapter 13. Pendency interest is not owing for the period preceding plan confirmation, but that period is usually only a few months. After confirmation the undersecured creditor will only receive interest on its secured claim. The rate will be set by the court, frequently at a rate that is less than the contract rate, and less than what the undersecured creditor could have earned if allowed to foreclose and reinvest the value of the collateral in some other way.³⁹ Furthermore, unless the collateral comprises the debtor's principal residence, the payment schedule can be modified in Chapter 13, extending the period of repayment for the secured claim to well beyond the contracted period, during which extension the creditor may be receiving a reduced rate of interest.

Even more serious, from the undersecured creditor's perspective, is the fact that stripping the lien is a common result of a Chapter 13 proceeding. This is because the lien will be considered satisfied if the payments received by the undersecured creditor through a Chapter 13 plan equal the value of the collateral at filing, plus whatever

³⁷ See notes 27-29, *supra*, and accompanying text.

³⁸ See *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988). This remarkable principle is of great importance in corporate reorganization, because it allows the bankruptcy estate to use the collateral without paying the time value of money, though adequate protection must be provided.

³⁹ For the interest rate paid on a secured claim in Chapter 13, see notes 14-17, *supra*, and accompanying text. The default rate of Chapter 13 plans far exceeds the default rate of almost any category of new loans, so the risk that substantial collection costs will be borne by the undersecured creditor after confirmation of a Chapter 13 plan far exceeds the equivalent risk in other contexts. The interest rates allowed in Chapter 13 are not likely to adequately account for this extra risk.

rate of interest is allowed. The creditor is also entitled under the Chapter 13 plan to whatever percentage of its deficiency or unsecured claim other unsecured creditors receive under the plan, but this percentage is often low.⁴⁰ Even if the plan is not successfully completed and the case is dismissed or converted to Chapter 7, the lien will be deemed satisfied if the allowed secured claim has been paid before plan failure.⁴¹ This happens with frequency because it is a common practice—though one that varies between districts—for debtor payments into Chapter 13 plans to be used to pay secured claims before distributions are made to unsecured creditors, and about two-thirds of Chapter 13 plans fail nationally.⁴²

It is clear that an undersecured creditor's interests are less well protected in Chapter 13 than they are in Chapter 7, both because of the frequency of inadequate interest payments and lien stripping in Chapter 13, and because of the easy availability of reaffirmations in Chapter 7. Anyone who takes the time to engage in casual conversation with an attorney who regularly represents secured creditors in consumer bankruptcy will learn that this contrast in the chapter proceedings is well understood by practitioners. The extent of this compromising of priority rights depends on a number of low visibility decisions about which there is a lack of information. Most obviously, there is the question of how interest rates are set in Chapter 13. There is also the question of what value is put on the collateral, since this is the amount that the creditor must receive, with interest, before lien stripping can occur. Legal precedents establish the standard for determining value⁴³ but, in Chapter 13 practice, the amount is agreed to in negotiations between the debtors' and creditors' attorneys. There is reason to believe that in many districts these negotiations result in a higher value than indicated by the

⁴⁰ The debtor is required to commit all "disposable income" to payments under the plan: see *Bankruptcy Code*, *supra* note 2, § 1325(b)(1)(B). In practice, however, this requirement has not sufficed to provide uniformity to Chapter 13 practice. Districts vary widely in the prevalence of confirmed Chapter 13 plans that provide low payments to undersecured creditors: see W.C. Whitford, "The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy" (1994) 68 *Am. Bankr. L.J.* 397 at 409-12; and J. Braucher, "Lawyers and Consumer Bankruptcy: One Code, Many Cultures" (1993) 67 *Am. Bankr. L.J.* 501.

⁴¹ There is no controlling authority on this point, but it appears to be the result applied in most bankruptcy districts: see K. Lundin, *Chapter 13 Bankruptcy* §8.20 (Eau Claire, Wis.: PESI Legal, 1992); and D.G. Carlson, "Bifurcation of Undersecured Claims in Bankruptcy" (1996) 70 *Am. Bankr. L.J.* 1.

⁴² See note 17, *supra*.

⁴³ See note 22, *supra*, and accompanying text.

legal standard.⁴⁴ Even assuming this to be correct, the fact remains that an undersecured creditor is almost always better off in Chapter 7 than in Chapter 13, primarily because in Chapter 7 it is likely the hostage value of the collateral can be recovered by the creditor through a reaffirmation agreement. Beneficiaries of a debtor's Chapter 13 choice commonly include unsecured creditors, who normally receive more in payments in Chapter 13 than they would have received in Chapter 7.

III. PROPOSALS FOR CHANGE

The first section will describe the changes recommended by the NBRC⁴⁵ respecting the status of secured claims in consumer bankruptcy. The second section will describe the changes under consideration by Congress.

A. Changes Recommended by the NBRC

Consumer bankruptcy was the most contested topic considered by the Commission. Most of the Commission's important recommendations were approved by a 5-4 vote, with the dissent writing an extensive report and advocating quite different provisions. In this article, however, I discuss only the Commission majority's

⁴⁴ In these districts, the debtor's total contributions to a Chapter 13 plan are determined by the disposable income test in section 1325(b)(2) of the *Bankruptcy Code*, *supra* note 2. The valuation set for the collateral will determine what percentage of the total contributions are paid to satisfy the secured claim, but it will not affect the debtor's total payments into the plan (assuming the plan is confirmed as proposed). In these circumstances, the debtor does not have great incentive to bargain for low valuation. If agreeing to a high valuation will get the secured creditor to support confirmation, that is frequently the path of least resistance. The Chapter 13 trustee, as representative of unsecured creditors, has an incentive to object to plans that set too high a value on collateral, however, and this may limit the extent to which debtors and secured creditors in effect expropriate the unsecured creditors' portion of Chapter 13 payments through agreement on a high value for collateral.

⁴⁵ The National Bankruptcy Review Commission was authorized by the *Bankruptcy Reform Act of 1994*, H.R. 5116, 103d Cong. §602 (1994), which charged the Commission with reviewing the *Bankruptcy Code* and recommending changes. Its nine members first began meeting in October 1995. The Commission held twenty-one public hearings and received over 2,000 written submissions from interested persons. Its report was published in October 1997: see National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years, Final Report* (Washington, D.C.: U.S. Government Printing Office, 1997), online: National Bankruptcy Review Commission <<http://www.nbrc.gov/reportcont.html>> (date accessed: 16 July 1999) [hereinafter *NBRC Report*]. Many of its recommendations concerned issues other than consumer bankruptcy and will not be discussed in this article.

recommendations. Many of the dissenters' proposals are incorporated in the congressional bills discussed in the next section. At the time of this writing (January 1999), it appears that most of the Commission majority's recommendations concerning consumer bankruptcy have little chance of congressional enactment.

1. Validity of security interests in bankruptcy

The Commission recommended a considerable expansion of the section 522(f)(1)(B) principle invalidating some nonpurchase-money security interests in household goods and other items when the security interest impairs an exemption. The expansion would encompass purchase money security interests when the value of the collateral at the time of bankruptcy filing is less than \$500.⁴⁶ The purpose of the proposed change is to invalidate security interests claimed by some credit card issuers on items obtained through use of the credit card. According to the Commission report, these credit extensions are not really asset-based lending, in the sense that the creditor does not rely on the collateral in any way in extending credit.⁴⁷ The debtor normally receives no interest rate discount or other benefit from granting a security interest in the items purchased with the card, and probably is unaware that the creditor is taking a security interest in items acquired through use of the credit card. In Chapter 7 bankruptcy, these security interests are often used to threaten the debtor with foreclosure, inducing the debtor to reaffirm the full amount owing in order to avoid repossession of items which frequently have a high hostage value, such as household goods.

2. Bankruptcy as default

The Commission recommended that the present split in case authority be resolved in favour of not permitting secured claims not in default at the time of filing to "ride through."⁴⁸ If enacted, debtors could

⁴⁶ See *NBRC Report*, *supra* note 45, Recommendation 1.3.4., discussed at 3-4.

⁴⁷ *Ibid.* at 169-74. The effective credit extension decision is made at the time the credit card is issued, and before the creditor has any idea what it will be used for. However, with some department store credit cards, such as those issued by Sears Roebuck or JCPenney, the issuer can be reasonably certain that the card will be used to acquire goods rather than services, therefore ensuring that there will at least be some collateral when the card is used.

⁴⁸ *Ibid.* Recommendation 1.3.3, discussed at 165-69.

avoid the lifting of the automatic stay and subsequent foreclosure on the collateral only by redemption of the collateral or reaffirmation of the debt in Chapter 7, or payment of the allowed secured claim in Chapter 13. The Commission recommended a limited exception for mortgages on the debtor's principal residence, which would be permitted to ride through if not in default at the time of filing.

3. Modifying the rights of oversecured creditors

As a modest deterrent to repeat filings as a strategy for avoiding foreclosure by the secured creditor, the Commission recommended that the automatic stay not be triggered if the debtor had filed twice within the preceding six years and the debtor has been a debtor in a different bankruptcy case within 180 days of the current filing.⁴⁹ If enacted, the effect of this recommendation would sometimes be to give a secured creditor 180 days after a bankruptcy dismissal or discharge to foreclose, free of worries of interference from another automatic stay.

The Commission's other recommendations relevant to the oversecured creditor relate principally to Chapter 13. It recommended the establishment of a uniform national standard for interest rates payable in Chapter 13, but specifically refused to endorse any particular standard.⁵⁰ However, the Commission's report states that the Commission's "previous discussions have referred to the six-month treasury bills rate as a starting point, with additional points added thereto for a risk premium."⁵¹ It is likely that any standard set in such a fashion would lead to interest rates that are less than the contract rate. The Commission would also require that payments on secured debts that are subject to modification be spread evenly throughout the period of the Chapter 13 plan, whereas presently, payments on secured loans are often "front loaded" into the early months or years of a plan.⁵² The most important practical consequence of spreading secured payments through the plan period is to prevent lien stripping in Chapter 13 when the plan is not successfully completed, which is of considerable benefit to the

⁴⁹ *Ibid.* Recommendation 1.5.5, discussed at 273-81.

⁵⁰ *Ibid.* Recommendation 1.5.3, discussed at 259-62.

⁵¹ *Ibid.* at 261. The Commission's comment appears to be an endorsement of the Second Circuit's opinion in *In re Valenti*, 105 F.3d 55 (2d Cir. 1997).

⁵² See *NBRC Report*, *supra* note 45, Recommendation 1.5.3, discussed at 262.

undersecured creditor.⁵³ For the oversecured creditor, who is not concerned about lien stripping, spreading secured payments over a longer period of time increases the period during which the oversecured creditor may be receiving interest payments at less than the contract rate.⁵⁴

The Commission recommended that the provision preventing modifications of real estate mortgages where the collateral is the debtor's principal residence be limited to first mortgages. Junior mortgages could be modified as other secured claims can be, including extension of the period for repayments, except that, for undersecured creditors, the size of the allowed secured claim could not be reduced to less than the appraised value of the collateral at the time the loan originated.⁵⁵

4. Modifying the rights of undersecured creditors

With respect to valuation of collateral, which determines how much of an undersecured creditor's claim will be considered secured, the Commission recommended substituting a "wholesale" value standard for the current "replacement" value standard.⁵⁶ In effect, valuation would look to what the secured creditor would likely obtain from foreclosure and resale, rather than what it would cost the debtor to replace the collateral through a retail purchase. The effect would be to reduce the portion of an undersecured creditor's total claim that would be deemed secured.

⁵³ Presumably, it would still be possible, when converting a case to Chapter 7, to receive credit for payments on secured claims made in Chapter 13, and then to redeem the collateral under section 722 of the *Bankruptcy Code*, *supra* note 2, by paying only the balance of the allowed secured claim as valued at the time of the Chapter 13 filing. The Commission did not recommend any change in section 348(f)(1)(B) of the *Code*, which in effect so provides.

⁵⁴ For a discussion of whether a secured creditor's non-bankruptcy entitlements with respect to interest are a proper measure of its priority rights in bankruptcy, see note 18, *supra*, and accompanying text. See also *NBRC Report*, *supra* note 45 at 259-62.

⁵⁵ See *NBRC Report*, *supra* note 45, Recommendation 1.5.1, discussed at 236-43. The intent is to permit modification of the increasingly common "home equity" loans where the amount of the loan exceeds the debtor's equity interest in the home at the time of loan origination. Such liens could thus be stripped in Chapter 13, with the indebtedness exceeding the value of the debtor's equity in the home at loan origination being considered an unsecured claim.

⁵⁶ *Ibid.* Recommendation 1.5.2, discussed at 242-58. The standard for real estate would be "fair market value, minus hypothetical costs of sale"—a figure roughly equivalent to what the creditor could obtain if foreclosure were allowed.

The Commission also recommended that reaffirmations be limited to the amount of the allowed secured claim, determined under the valuations standards just described.⁵⁷ The practical effect of this recommendation, if adopted, is likely to be far reaching. There is nothing to require a secured creditor to agree to a reaffirmation. In Chapter 7, the creditor has the option of foreclosing on the collateral after the automatic stay lapses, and I believe this option will often be more attractive to the creditor than the limited reaffirmation that would be permitted under the Commission's proposal.⁵⁸ As a consequence, the only practical option for a debtor who wishes to retain collateral would usually be to file under Chapter 13.⁵⁹

Within Chapter 13, the principal recommended changes are those discussed in the preceding section of this article on the oversecured creditor. These include the standardization of interest rates, the requirement that payments on secured claims be spread over the entire plan, and the ability to modify junior real estate mortgages.

B. Changes Under Consideration in the United States Congress

Congress has yet to enact any significant changes in the American consumer bankruptcy regimes. However, the House of Representatives enacted a comprehensive reform bill in June 1998, and the Senate enacted a significantly different comprehensive bill in September 1998.⁶⁰ A Conference Committee recommended a compromise between the two different bills, but the compromise was not

⁵⁷ *Ibid.* Recommendation 1.3.1, discussed at 145-61. Presumably, the agreement could also include interest for the period of repayment provided in the reaffirmation agreement, though the Commission's recommendation neither makes that clear, nor provides a standard for limiting the agreed interest rate.

⁵⁸ Either course will provide the creditor with about the same amount. However, foreclosure would represent a "bird in the hand," whereas reaffirmation would represent simply the debtor's promise to pay—a promise which would not always be performed.

⁵⁹ Another option for the debtor would be to redeem the collateral under section 722 of the *Bankruptcy Code*, *supra* note 2, but this is usually not a practical choice. Encouragement to file Chapter 13 appears to have been a contemplated consequence: see Warren, *supra* note 17 at 500-01. Elizabeth Warren was a Reporter to the Commission and advisor to the consumer bankruptcy working group.

⁶⁰ See *Bankruptcy Reform Act of 1998*, H.R. 3150, 105th Cong. (1998) [hereinafter "House bill"], as passed by the House of Representatives on 5 June 1998. This bill was later amended and passed by the Senate on 23 September 1998: see H.R. 3150, 105th Cong. (1998) (Engrossed Senate Amendment) [hereinafter "Senate bill"], and then amended again by the *Conference Report*, *infra* note 61, which was passed by the House on 9 October 1998.

approved by the Senate before the adjournment of the last Congress.⁶¹ Proponents of the *Conference Report* introduced a facsimile in the current session of Congress and it has been enacted by the House of Representatives.⁶² At the time of this writing (July 1999), debate is continuing in the Senate. It remains unclear whether, when, or what Congress will do.

The following discussion will summarize the principal provisions of last session's House and Senate bills, and the *Conference Report* respecting secured credit. It is likely that any legislation will be some combination of these three documents. As noted above, there is little relation between the majority recommendations of the NBRC and the proposals now under active consideration by Congress.

1. Validity of security interests in bankruptcy

Both bills and the *Conference Report* would limit the type of collateral for which nonpurchase-money security interests are considered invalid in bankruptcy under section 522(f)(1)(B) by adopting a narrower definition of household goods than is currently the rule.⁶³

2. Bankruptcy as default

The *Conference Report* and the House bill would prohibit ride through of secured claims not in default at the time of bankruptcy filing, if the underlying contract provides that a bankruptcy filing constitutes a

⁶¹ When the House of Representatives and the Senate enact conflicting legislation on the same topic, it is common (though not required) for each body to appoint members to what is called a Conference Committee to draft a bill compromising the disagreements between the two bodies. The resulting "Conference Report" must then be enacted by each body before presentation to the President for his signature. In the present case, the Conference Report took the form of an amendment to H.R. 3150: see H.R. Rep. No. 105-794 (1998) [hereinafter *Conference Report*].

⁶² See *Bankruptcy Reform Act of 1999*, H.R. 833, 106th Cong. (1999), passed on 5 May 1999.

⁶³ See House bill, *supra* note 60, § 122; Senate bill, *supra* note 60, § 317; and *Conference Report*, *supra* note 61, § 148. The proposals vary in detail, with the House bill being the most restrictive. The House bill would render section 522(f)(1)(B) of the *Bankruptcy Code*, *supra* note 2, mostly redundant, because the section would apply only to "household goods" as that term is defined in the FTC rule prohibiting nonpurchase-money security interests in a narrow range of household collateral: see *FTC Credit Practice Rule*, *supra* note 6, §§ 444.1(i), 444.2(4). If a security agreement is invalid outside bankruptcy, because it is violative of a FTC rule, there is no function for a rule of invalidity in bankruptcy.

default.⁶⁴ In such circumstances, if the debtor did not redeem the collateral, reaffirm the debt, or complete a Chapter 13 plan, the creditor could foreclose once the automatic stay has been terminated.

3. Modifying the rights of oversecured creditors

Both bills and the *Conference Report* contain more severe deterrents to repeat filers than was recommended by the NBRC. All three proposals are similar; in instances of a second bankruptcy filing within a year, the automatic stay would terminate within thirty days unless the debtor made an affirmative showing of good faith.⁶⁵

No provision was made in any of the congressional bills for interest payments in Chapter 13. The House bill, but neither of the other proposals, required that unsecured creditors receive at least \$50 per month under a Chapter 13 plan.⁶⁶ This was the only provision in any of the bills that would affect the present practice of front loading payments to secured creditors in Chapter 13 plans.

4. Modifying the rights of undersecured creditors

The most significant changes affecting undersecured creditors concern bifurcation of secured claims in Chapter 13. The Senate bill would prohibit bifurcation altogether, eliminating lien stripping and requiring payment of the full amount owing before a lien would be released.⁶⁷ The *Conference Report* limited its prohibition of bifurcation to purchase money security interests in personalty acquired within five years of filing, but it applies this prohibition to Chapter 7 as well as

⁶⁴ See *Conference Report*, *supra* note 61, § 122(2)(D); and House bill, *supra* note 60, § 124.

⁶⁵ See *Conference Report*, *supra* note 61, § 119; House bill, *supra* note 60, § 121; and Senate bill, *supra* note 60, § 303. Additionally, if a court finds that a bankruptcy filing was part of a scheme to defraud real estate secured creditors involving multiple bankruptcy filings, the court could enter an *in rem* order, which would prevent the automatic stay from arising in subsequent bankruptcies with respect to specified real estate: see *Conference Report*, *supra* note 61, § 120; House bill, *supra* note 60, § 121; and Senate bill, *supra* note 60, § 731.

⁶⁶ See House bill, *supra* note 60, § 102.

⁶⁷ See Senate bill, *supra* note 60, § 302.

Chapter 13.⁶⁸ The *Conference Report* prohibition would prevent lien stripping of most motor vehicle loans.

Eliminating the possibility of lien stripping in Chapter 13 removes one of the most important incentives for a debtor to choose Chapter 13 under the current statute.⁶⁹ The change is part of an important proposed shift in basic philosophy underlying consumer bankruptcy. The current statute relies largely on a "carrot" approach to encouraging debtors to choose Chapter 13 over Chapter 7. All pending congressional legislation considerably strengthens provisions that would deny some debtors access to Chapter 7, and force them to select Chapter 13 if they wish bankruptcy relief. Called "means testing" or "needs-based bankruptcy" in the political rhetoric accompanying the proposals, the idea is to require debtors who can afford to repay a significant portion of their unsecured claims to file under Chapter 13.⁷⁰

This shift from a "carrot" to a "stick" approach to encourage Chapter 13 filing underlies the provisions in the pending legislation concerning reaffirmations. Whereas the NBRC proposed severely restricting the availability of reaffirmations in Chapter 7, as a way of encouraging debtors to select Chapter 13 in order to preserve possession of collateral,⁷¹ the *Conference Report* and House bill contain no new significant restrictions on the availability of reaffirmations for secured claims.⁷²

⁶⁸ See *Conference Report*, *supra* note 61, § 124. The most important practical effect of prohibiting bifurcation in Chapter 7 would be to increase to the full amount owing what a debtor must pay in order to redeem the collateral under section 722 of the *Bankruptcy Code*, *supra* note 2. The House bill would limit bifurcation only for purchase money security interests of personally acquired within 180 days of filing: see House bill, *supra* note 60, § 128. However, the House bill would prohibit lien stripping in an uncompleted Chapter 13 plan, even if the allowed secured claim were paid in full: *ibid.* § 127. This provision is also contained in the Senate bill and the *Conference Report*, though it has no practical effect to the extent bifurcation is prohibited.

⁶⁹ I canvass the reasons that a debtor might select Chapter 13 in his or her self-interest, in W.C. Whitford, "Has the Time Come to Repeal Chapter 13?" (1989) 65 Ind. L.J. 85 at 99-101 [hereinafter "Has the Time Come?"]. See also J.A. Logan, "The Troubled State of Chapter 13 Bankruptcy and Proposals for Reform" (1998) 51 SMU L. Rev. 1569 at 1578, 1585-86.

⁷⁰ See *Conference Report*, *supra* note 61, § 102; House bill, *supra* note 60, §§ 101, 103; and Senate bill, *supra* note 60, § 102. The provisions differ in important details. It is beyond the scope of this article to describe these details, or to comment on whether the proposals would be effective at accomplishing their professed ends, though there is a great controversy about both topics.

⁷¹ See notes 57-59, *supra*, and accompanying text.

⁷² The Senate bill would require court approval, under conditions not likely to be satisfied, for reaffirmations of purchase money secured claims if the collateral was worth less than \$250 at the time of purchase: see Senate bill, *supra* note 60, § 211. The idea of this provision is to deter reaffirmation for the full amount owing of secured claims where the collateral is household goods of limited value.

All pending congressional legislation would retain the current replacement value standard for valuing collateral, though this rule has limited relevance if bifurcation is prohibited.

IV. MY PROPOSALS FOR CHANGE

I object to compromising the interests of secured creditors in Chapter 13 in order to provide debtors with an incentive to select that chapter, rather than Chapter 7. I believe the rights of secured creditors should be substantially the same in the two chapters. There is no question that most unsecured creditors benefit if a debtor elects Chapter 13.⁷³ But usually today, a secured creditor—and especially an undersecured creditor—will prefer a debtor to select Chapter 7, because of the quicker relief from the automatic stay and, most importantly, because of the possibility of reaffirmations in Chapter 7, coupled with the availability of lien stripping in Chapter 13. I do not believe that redistributing wealth from secured to unsecured creditors in consumer bankruptcy is ordinarily just, yet this is what normally happens when the debtor selects Chapter 13. It is often argued that there is a public interest in having debtors select Chapter 13. If there is a public benefit in having debtors select Chapter 13, somebody other than secured creditors should be asked to bear the costs.⁷⁴

This position puts me in opposition to some of the recommendations of the NBRC. The Commission recommended continuation of the traditional approach of encouraging debtors to choose Chapter 13 by offering them incentives to do so.⁷⁵ More favourable treatment of secured debts has long been one of the most important incentives offered to debtors by the *Bankruptcy Code*. The

⁷³ This is not true for an unsecured creditor whose claim is non-dischargeable in Chapter 7. Such a creditor would normally prefer Chapter 7, where most unsecured claims would be discharged, lessening the debt repayment demands on the debtor's future income.

⁷⁴ I earlier articulated this position in "Has the Time Come?," *supra* note 69 at 99-101.

⁷⁵ The majority of the NBRC never took a position on "means testing" or "needs-based bankruptcy": see note 70, *supra*, and accompanying text. It is possible that the majority believed there was a political imperative to increase the number of Chapter 13 proceedings, and that by providing incentives for debtors to choose Chapter 13 they might discourage adoption of means testing or needs-based bankruptcy. However, the majority never gave that rationale for their position.

Commission recommended enhancing this incentive by limiting the availability of reaffirmations in Chapter 7.⁷⁶

One way to make a secured creditor's rights similar in Chapters 7 and 13 would be to allow a debtor to redeem collateral under section 722 by installments, including the payment of reasonable interest. Then there would be a practical way to strip an undersecured creditor's lien in Chapter 7, as there is now in Chapter 13, and reaffirmations for the full amount owing with respect to collateral eligible for redemption under section 722 would be rare.⁷⁷ There would be no need to prohibit such reaffirmations, as the NBRC recommended, because debtors would not agree to them in any event, having a superior means of retaining their collateral. I advocated such a solution in the past because I believed it was inappropriate to permit a secured creditor to threaten foreclosure and destruction of the hostage value of collateral as a way of inducing a reaffirmation for the full amount owing.⁷⁸

Another way to assimilate secured creditors' rights in Chapters 7 and 13 is to give secured creditors the same rights in Chapter 13 that they now have in Chapter 7. The pending congressional legislation prohibiting bifurcation of undersecured claims in Chapter 13 moves in this direction.⁷⁹ It would require debtors to pay the full amount owing over the period of the Chapter 13 plan, a result resembling a reaffirmation of the full amount of the debt. However, in Chapter 13 the creditor has little opportunity to bargain with the debtor over such matters as the interest rate or the period of repayment. A more complete equalization of the undersecured creditor's position in Chapter 7 and 13 would give the creditor the same rights to relief from the

⁷⁶ At first glance, limiting reaffirmations to the value of the collateral, as the NBRC recommends, would seem to make Chapter 7 more like Chapter 13, where lien stripping flourishes. As I have argued above, so long as the creditor has a right to relief from the automatic stay, the creditor will not agree to a reaffirmation for the market value of the collateral, preferring repossession and resale: see notes 58-59, *supra*, and accompanying text. The only way the debtor will be able to retain the collateral will be to file a Chapter 13.

⁷⁷ Section 722 of the *Bankruptcy Code*, *supra* note 2, is limited to tangible personalty. However, in consumer bankruptcy, real estate collateral is most likely to be the debtor's residence, and secured claims in such collateral cannot be modified or stripped in Chapter 13. An arrearage in real estate mortgages can be cured in Chapter 13 without the creditor's consent (§ 1322(b)(5)), and this is another reason debtors choose Chapter 13: see authorities cited in note 69, *supra*. It would be consistent with the policy position discussed in the text to amend Chapter 7 to provide a similar right of cure for real estate mortgages.

⁷⁸ See "Has the Time Come?," *supra* note 69 at 100.

⁷⁹ The Senate bill would prohibit all bifurcation of undersecured claims. The *Conference Report* limited the prohibition of bifurcation to purchase money security interests in personalty obtained within five years of filing: see notes 67-68, *supra*, and accompanying text.

automatic stay in Chapter 13 as now exist in Chapter 7.⁸⁰ If an undersecured creditor could obtain relief from the automatic stay in Chapter 13, a debtor could retain collateral in Chapter 13 only with the secured creditor's consent. As a practical matter, the creditor would normally allow the debtor to keep the collateral, as now normally occurs in Chapter 7 through the reaffirmation process, if the debtor's Chapter 13 plan provided for payments to the undersecured creditor on terms agreeable to the latter.

I have now come to favour the second alternative with respect to most purchase money security interests. To prevent what I would regard as excessive exploitation of hostage value, I would limit payments to secured creditors in Chapter 13 to the full amount owing, with reasonable interest, and I would place similar limits on reaffirmations in Chapter 7.⁸¹

My motive for this change in position is in part practical. Equalizing the rights of secured creditors in Chapters 7 and 13, in order to eliminate what I regard as an unwise incentive for debtors to select Chapter 13, is much more achievable politically by increasing the rights of secured creditors in Chapter 13 than it is by reducing secured creditor rights in Chapter 7.

I also believe that increasing the rights of secured creditors may encourage a credit market in which there is a substantial difference in the cost to borrowers of secured and unsecured credit. Assuming consumers are able to make informed choices, it is in their collective interest to have alternatives available to them in the market. This includes a choice between secured credit, with enhanced creditor collection rights, at lower interest rates, and unsecured credit, with lesser creditor collection rights, at higher rates. Important categories of secured consumer credit, such as home mortgages and motor vehicle loans, are usually available at interest rates substantially lower than rates for generally available unsecured credit, such as the rates on credit

⁸⁰ Technically, section 362(d)(2) of the *Bankruptcy Code*, *supra* note 2, should be amended to provide that in Chapter 13, as in Chapter 7, the creditor is entitled to relief from the stay in all cases in which the debtor does not have any equity in the collateral. Under the present rules, the creditor must additionally show that the collateral is not necessary for an effective reorganization—a condition that courts consider hard to satisfy in the Chapter 13 context (because the debtor needs the car to get to work, or other collateral to maintain his or her resolve to complete a Chapter 13 plan, etc.).

⁸¹ Section 524(c), *ibid.*, does not now contain an express prohibition on reaffirmations for more than the amount owing (plus reasonable interest), though I am unaware of reports of reaffirmations for such amounts. The suggested prohibition would require some regulation of interest rates in both Chapter 13 and reaffirmations to prevent avoidance of the limit on payments to secured creditors through excessive interest.

cards. It seems reasonable to assume that the enhanced collection rights of secured creditors are partly responsible for these interest rate differences.⁸² If these collection rights are not respected in bankruptcy, and clearly the rights of undersecured creditors are substantially compromised in Chapter 13, it risks undercutting the economic basis for a differential in the cost of secured and unsecured credit.

My proposal for enhancing the rights of undersecured creditors in bankruptcy is limited to most purchase money security interests for two reasons. Hostage value exists because the collateral has a unique value to the debtor that cannot be transferred to another owner. A creditor's threat to repossess and resell collateral is a threat to destroy that hostage value, unless the debtor shares that unique value with the creditor by paying the creditor more than it could obtain from repossession and resale. Agreements made in response to threats to destroy value unless the owner pays money are often voidable for duress, and it is easy to regard a typical reaffirmation agreement for the full amount owing as similarly flawed.⁸³ On the other hand, reaffirmations for the full amount owing undoubtedly reduce creditors' costs, in turn holding down the cost of secured credit. While I am endorsing reaffirmations for the full amount owing, and the prohibition of lien stripping so that creditors can obtain those reaffirmations by threatening to destroy hostage value, I am more comfortable doing so only for purchase money security interests. So long as reaffirmations are capped at the full amount owing, there is a natural limit to the exploitation of hostage value for purchase money security interests. At the time of loan origination, the amount owing approximates the market value of the collateral, and a gap between the two amounts (making the creditor undersecured) develops only because the former declines at a lesser rate than the latter. However, the gap does not usually grow too large as a

⁸² There are also underwriting differences between the different categories of loans, which account in substantial part for the rate differentials. Often it is easier for the marginally creditworthy borrower to obtain a credit card than a car loan or a home mortgage.

⁸³ American Law Institute, *Restatement of the Law, Second: Contracts 2d* (St. Paul, Minn.: American Law Institute, 1981) at § 175(1) includes in its definition of duress an agreement in which one party's assent "is induced by an improper threat ... that leaves the victim no reasonable alternative." Section 176(2), *ibid.*, includes in its definition of "improper threats," a situation where the resulting exchange is not on fair terms, and "the threatened act would harm the recipient and would not significantly benefit the party making the threat." An unsecured creditor's threat to repossess, unless the debtor reaffirms for the full amount owing, can be seen as a threat to harm the debtor by destroying hostage value without significantly benefitting the creditor whenever the debtor has offered to reaffirm for what the creditor could obtain from resale.

percentage of the collateral's market value.⁸⁴ In the case of nonpurchase-money security interests, on the other hand, the gap between the amount owing and the market value of the collateral may be large from the very beginning, and hence the possibility of very substantial exploitation of hostage value is much greater.

My second reason for limiting the enhancement of the bankruptcy position of the undersecured creditor to purchase money security interests relates to the ongoing debate in the legal literature about the efficiency of security interests in commercial lending.⁸⁵ The most serious concern expressed by scholars is that the availability of security encourages a later lender to extend credit that the lender would not be willing to extend without security. This additional credit then enables an overextended debtor to invest in risky projects that would not be funded by anyone who stood to suffer the losses if the projects fail.⁸⁶ This concern, developed in the context of business lending, is not irrelevant to consumer lending. Although consumers on the verge of bankruptcy do not usually make risky investments,⁸⁷ excessive availability of credit can cause them to maintain a lifestyle that is more extravagant than their income justifies, or is necessary. Many business lending commentators agree that there is less concern about the efficiency of purchase money security interests.⁸⁸ Lenders taking such security interests are providing the wherewithal to permit the debtor to

⁸⁴ There is an exception for purchase money security interests in household furnishings because their market (*i.e.*, resale) value often declines to very little almost as soon as they are first put into use. This is the rationale for the NBRC's proposal to invalidate in bankruptcy purchase money security interests where the market value of the collateral is less than \$500: see notes 46-47, *supra*, and accompanying text. I endorse this proposal and, even if it is not adopted, I would not allow reaffirmations for the full amount owing with respect to such collateral in either Chapter 7 or Chapter 13. With respect to such collateral, lien stripping should be facilitated.

⁸⁵ For a recent summary of literature, see R.E. Scott, "The Truth About Secured Financing" (1997) 82 Cornell L. Rev. 1436 [hereinafter "The Truth About Secured Financing"].

⁸⁶ See L. Bebchuk & J. Fried, "The Uneasy Case For the Priority of Secured Claims in Bankruptcy" (1996) 105 Yale L.J. 857. Overextended debtors have an incentive to invest in risky projects because they bear little risk of additional loss—risk that is borne by existing creditors, who will get paid even less—but may stand to reap much of the gain. For a detailed account of the investment incentives of overextended debtors, see L.M. LoPucki & W.C. Whitford, "Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies" (1993) 141 U. Pa. L. Rev. 669 at 683-84.

⁸⁷ However, there have been increasing concerns about consumers turning to gambling in a desperate final attempt to solve their financial woes: see E. Drought, "Navigating Scylla and Charybdis: *In re Briese*, Gambling, and Credit Card Dischargeability" Note (1997) Wis. L. Rev. 1323.

⁸⁸ See "The Truth About Secured Financing," *supra* note 85 at 1452; and H. Kanda & S. Levmore, "Explaining Creditor Priorities" (1994) 80 Va. L. Rev. 2021.

acquire an asset not previously owned. Therefore, purchase money security interests do not remove assets from a bankruptcy distribution that would have been available to unsecured creditors but for the secured lending.

V. CONCLUSION

I have chosen not to offer my opinion on all issues concerning secured creditors in bankruptcy. Instead, I have stressed the situation of the undersecured creditor in bankruptcy. American law facilitates lien stripping of undersecured claims, to an extent that most other countries would regard as remarkable and as an infringement on contractual freedom. I have reached the conclusion that lien stripping should be prohibited for purchase money security interests in all chapters of the *Bankruptcy Code*. Even more importantly, I believe that the rights of undersecured creditors should be the same in both Chapters 7 and 13. The historic position of sacrificing the interests of the undersecured creditor in order to create an incentive to file under Chapter 13 should be abandoned.