

New Challenges for Attorneys Signing Reaffirmation Agreements: Meeting a Heightened Standard of Judicial Review

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Duties of Debtor's Counsel

The attorney's declaration under Bankruptcy Code Section 524 that a reaffirmation agreement imposes no "undue hardship" upon the debtor client has always carried the potential for conflict unique to bankruptcy law. Potentially, it pits the lawyer's duty to advocate for clients who wish to reaffirm pre-petition debt, usually to retain goods that secure the debt, against the totally independent duty under Section 524(c) to certify that a reaffirmation imposes "no undue hardship" on the client. Reaffirmation abuses described in *In re Latanowich* and in the National Bankruptcy Review Commission Final Report have spawned heightened judicial scrutiny of the attorney's duties before signing the Section 524 declaration. In cases such as *In re Hovestadt*² and *In re Bruzzese*³, and especially the recent case of *In re Melendez*⁴, judges have examined in detail the lawyers' diligence, or lack thereof, in investigating whether their clients should sign a reaffirmation agreement.

However, a new form of disclosure statement and reaffirmation agreement recently promulgated by the Administrative Office of the United States Courts (AOUSC) has provided attorneys with a useful tool for meeting their obligations. New Form B240 not only facilitates judicial review of reaffirmation agreements, but also informs the

¹The views expressed in this article are those of the authors and should not necessarily be attributed to the U.S. Department of Justice or the United States Trustee Program.

²193 B.R. 382 (Bankr. D. Mass. 1996).

³214 B.R. 444 (E.D. N.Y. 1997).

⁴224 B.R. 252 (Bankr. D. Mass. 1998); 235 B.R. 173 (Bankr. D. Mass. 1999).

debtor of the consequences of the reaffirmation and acts as a checklist for counsel to consider before signing the Section 524(c) declaration. Form B240 has already been adopted in at least two jurisdictions, the Northern District of California and the District of Massachusetts. We suggest that debtor's counsel use the form even if it is not required by local rule.

Evolution of Section 524: Contradictory Roles

As initially enacted in 1978, Section 524 prescribed a formal reaffirmation process in order to preserve the paramountcy of a debtor's discharge. It required a bankruptcy court to determine, upon hearing and notice, whether a proposed reaffirmation agreement was in a debtor's best interest and did not impose an "undue hardship" on a debtor or her dependents. A hearing was required in every case.

Congress partially streamlined the reaffirmation procedure in 1984 by making reaffirmation agreements negotiated with the assistance of counsel effective upon filing, subject to an attorney's certifying that the agreement imposed no "undue hardship" on the debtor or a dependent. Amendments enacted in 1994 further required the attorney to certify that she had fully advised her client of the legal consequences of reaffirmation and default and that the agreement represented a fully informed and voluntary decision.

While not vitiating the bankruptcy court's oversight of the reaffirmation process, amended Section 524(c) shifted the onus of reviewing a reaffirmation agreement to the debtor's attorney. It thus placed a debtor's attorney in a contradictory role--serving as the advocate for her client's interests, but being required to "veto" the debtor's decision to reaffirm by not executing a supporting affidavit if she believed, in the exercise of her independent judgment, that doing so would impose an undue hardship.

For a time, bankruptcy courts were content to take attorney declarations at face value, opting not to question their reasonableness under the circumstances. But some judges noticed that attorneys were submitting statements supporting reaffirmation agreements where a debtor's Schedule "J" monthly expenses exceeded her Schedule "I" monthly income, suggesting that the attorneys' scrutiny was, at best, perfunctory. While some debtors might have deliberately understated income and overstated expenses to avoid dismissal for substantial abuse

under Section 707(b), this was hardly an issue for the poorest debtors, some of whom were on welfare or showed no income at all.

Circuit Split on "Ride Through"

If the debtor seeks to reaffirm in order to retain collateral, as opposed to obtaining new credit, the dilemma may be exacerbated in those judicial circuits that do not allow a "ride through"--the so-called "fourth option." Section 521(2)(A) requires a debtor, within 30 days of the petition date, to file a statement as to whether he intends to surrender, to reaffirm, or to redeem estate property securing pre-petition consumer debt. Section 521(2)(B) requires the debtor, within 45 days, to perform his stated intention. Four Circuit Courts of Appeal--the Second, Fourth, Ninth, and Tenth⁵--have held that a debtor who is current on payments has a fourth option under Section 521 of continuing to make payments without either reaffirming the debt or redeeming or surrendering the property, thereby "riding through" the bankruptcy and converting the original obligation to a non-recourse loan.

The First, Fifth, Seventh, and Eleventh Circuits⁶, however, have held that a debtor must elect and then perform only one of the three options listed in Section 521--surrender, reaffirmation, or redemption. If a debtor wishes to keep the collateral and cannot afford to redeem for fair

⁵See *Capital Communications Federal Credit Union v. Boodrow (In re Boodrow)*, 126 F.3d 43, 53 (2d Cir. 1997), cert. denied, 118 S.Ct. 1055 (1998); *Home Owners Funding Corp. of America v. Belanger (In re Belanger)*, 962 F.2d 345, 347-348 (4th Cir. 1992); *McClellan Federal Credit Union v. Parker (In re Parker)*, 139 F.3d 668, 672-673 (9th Cir. 1998), cert. denied, 119 S.Ct. 592 (1998); and *Lowry Federal Credit Union v. West*, 882 F.2d 1543, 1546-1547 (10th Cir. 1989).

⁶See *Bank of Boston v. Burr (In re Burr)*, 160 F.3d 843 (1st Cir. 1998); *Johnson v. Sun Fin. Co. (In re Johnson)*, 89 F.3d 249, 250-252 (5th Cir. 1996); *In re Edwards*, 901 F.2d 1383, 1385-1387 (7th Cir. 1990); and *Taylor v. AGE Federal Credit Union (In re Taylor)*, 3 F.3d 1512, 1516-1517 (11th Cir. 1993).

market value or persuade the creditor to "ride along," his sole option is to reaffirm. Some cases have held that a debtor and his attorney bear the burden of diligently performing his stated intention; the court in *In re Donnell*⁷ recently indicated that the Chapter 7 trustee, consistent with duties imposed under Section 704(3), must monitor the debtor's progress in doing so. In *In re Harris*⁸, the court even held that a debtor's failure to effectuate intentions stated under Section 521 was a ground for dismissal of the case "for cause" under Section 707(a). Thus, in those circuits that do not provide a ride through, the options available to the debtor are fewer and the pressure on debtor's counsel to sign a declaration supporting reaffirmation may be greater.

Hovestadt, Bruzzese, and Melendez

In *Hovestadt, Bruzzese, and Melendez*, the debtors sought to reaffirm pre-petition debts, which they could not repay with their post-discharge net income, as indicated by Schedules "I" and "J." In *Hovestadt* and *Melendez*, the debtors sought to reaffirm in order to keep consumer goods; in *Bruzzese*, they sought to reaffirm as a prerequisite to obtaining additional post-discharge store credit. Counsel in each case certified that reaffirmation imposed no "undue hardship" and that the agreements were voluntary and informed.

The courts, after reviewing the agreements, issued orders requiring the debtors and their attorneys to show cause why they should not be sanctioned for seeking to reaffirm, given the debtors' inability to pay their living expenses, let alone the additional reaffirmed debts. In *Melendez*, the court directed the show cause orders to eight different debtors and their counsel. Each court determined that, despite the 1984 amendments to the Bankruptcy Code, it had an independent duty to review the debtors' reaffirmation agreements under Section 524(c).⁹

⁷234 B.R. 567 (Bankr. D.N.H. 1999).

⁸226 B.R. 924, 926 (Bankr. S.D. Fl. 1998).

⁹Recently, the District Court for the District of Massachusetts, concurring with the position of the United States Trustee, affirmed that bankruptcy courts "possess an independent obligation to ensure that the elements of Section

The courts ultimately struck the attorneys' supporting statements under Bankruptcy Rule 9011, nullifying the reaffirmation agreements, because the attorneys appeared to have ignored the debtors' financial circumstances and failed to advise the debtors of alternatives to reaffirmation, such as redemption under Section 722. The *Melendez* court held that Rule 9011 required attorneys to make a reasonable inquiry based upon "the totality of the circumstances" before signing a Section 524(c) declaration. The *Bruzzese* court required the debtors' counsel to refund \$200 as "excessive compensation" for the services performed for the debtors in connection with the case. Monetary sanctions were not levied against the attorneys in *Hovestadt* or *Melendez*, but in both cases the court indicated it would consider doing so in the future.

The *Melendez* court held that, for a Section 524(c) declaration to pass muster under Rule 9011, a debtor's attorney must: establish whether the debtor can pay the reaffirmed debt; review the security agreement and sales receipt, verify the creditor's claim and determine the extent, validity and perfection of the creditor's purported security interest; independently estimate the value of the collateral; evaluate the risk of replevy by the creditor; discuss the relevant financial disclosures with the debtor; ensure that the agreement was entered into voluntarily and without creditor misrepresentations or coercion; ensure that the debtor understands the effect of the agreement and the consequences of default; ensure that the debtor is informed as to his options as to the collateral; and advise the debtor regarding alternative sources of credit.

Although daunting at first blush, the list of "to do's" can best be addressed by using a new form reaffirmation agreement offered by the AOUSC.

The AOUSC's Form B240

On June 17, 1999, the AOUSC issued a proposed reaffirmation agreement, Form B240, which addresses at least some of the concerns raised by *Bruzzese* and *Melendez*. An

524(c) are satisfied," even when reaffirmation agreements are accompanied by attorneys' declarations. *In re Nanton*, __ B.R. __, 1999 WL 781674, Sept. 24, 1999.

attorney who follows the form will go a long way toward meeting her obligations of reasonable inquiry under the circumstances and informing the client of the consequences of reaffirmation.

The form was developed as the result of a recommendation by the National Bankruptcy Review Commission. In its final report issued Oct. 20, 1997, the commission recommended that the United States Judicial Conference's Advisory Committee on Bankruptcy Rules "prescribe a form motion for approval of reaffirmation agreements that contains information enabling the court and the parties to determine the propriety of the agreement."¹⁰ Approval of the motion would not entail a separate court order, the commission stated.

The commission reported that the use of reaffirmation agreements was far more prevalent than previously estimated and that Section 524 did not always work as intended. The commission's report cited a National Survey of Bankruptcy Debtors commissioned by Visa, which stated that 52 percent of the debtors reported reaffirming one or more debts and that 50 percent of the reaffirmations filed were for unsecured, nominally secured, or undersecured debt. As to the role of debtor's counsel, the report stated:

Some debtors' attorneys refuse all requests for reaffirmations, while others believe that debtors can benefit from carefully chosen reaffirmation agreements. However, other attorneys apparently believe that they should not interfere in the reaffirmation decision. In the absence of zealous, well-informed counsel, many debtors commit to significant post-discharge obligations. The burden of economically unwise reaffirmations falls especially hard on the debtors with the fewest resources to hire careful counsel.¹¹

Using the Form to Discharge Counsel's Duties

Given the history of abuses and the trends in case law,

¹⁰Final Report of the National Bankruptcy Review Commission at 145-146.

¹¹Id. at 154.

debtors' counsel should negotiate reaffirmation agreements more carefully. Clients and counsel both need to make informed and defensible decisions where the monetary stakes may be small but the client's stake in her property is critically important. The following is a brief discussion of how counsel can meet her obligations and how the new form can be helpful.

Does Reaffirmation Impose An "Undue Hardship?"

In evaluating whether a proposed reaffirmation agreement imposes an "undue hardship," an attorney should first understand her client's financial situation, as expressed most basically in household income and expenses listed on Schedules "I" and "J," which she should be prepared to update as needed. While acknowledging that the Bankruptcy Code does not define "undue hardship," the *Melendez* court generally offered that it "would deem reaffirmation to cause a debtor 'undue hardship' where it would result in a significant, but otherwise avoidable, obstacle to the attainment or retention of necessities by the debtor or the debtor's dependents."¹²

If the debtor will realize positive, post-discharge net income, neither the agreement nor the certification should pose a problem, because "payment of a reaffirmed debt cannot constitute an undue hardship where the funds come from disposable income."¹³ However, if the debtor's post-discharge expenses will exceed his income and/or the debt exceeds the likely value of any collateral securing it, the attorney should consider other factors, which implicate whether the debtor's decision to reaffirm is both fully informed and voluntary.

Counsel should consider the type of collateral involved. If the collateral is the debtor's residence or automobile, reaffirmation may be more justifiable, "because those [are] items of indisputable necessity and substantial value regardless of the terms offered by the creditor and because failure of the debtor would likely result in foreclosure and replevy..."¹⁴ But for collateral such as household items, the attorney must evaluate necessity in light of the replacement

¹²*In re Melendez*, 224 B.R. at 261.

¹³*Id.*, at 270, n. 23.

¹⁴*Id.*, at 181, n. 2

cost, "taking into consideration age, obsolescence or other factors that might render it valueless..."¹⁵

Critically important is an evaluation of whether the creditor will seek to replevy or foreclose on the collateral, and if it does, whether the client has an alternative. Ultimately, evaluating the likelihood of repossession is a crucial, and perhaps the most difficult, element of the attorney's advice.¹⁶

Is The Agreement Informed And Voluntary?

The cover page alone of Form B240 helps an attorney meet her obligation to assure that a reaffirmation agreement is informed and voluntary. The form's first page is a plainly worded "Notice to Debtor." It advises that: the agreement gives up the protection of the bankruptcy discharge, the creditor can act to collect the debts, there is a right of recession, the debtor is not obligated to enter into the agreement, the debtor can pay the debt without signing the agreement, and there is a right of redemption.

The attorney should explain the financial terms of the reaffirmation agreement, including interest on the debt and other associated costs. Form B240 encourages such an explanation by requiring disclosure of the amount of the debt reaffirmed and the composition of that debt, such as whether it includes accrued interest, attorney's fees, or late fees. It also requires disclosure of the interest rate, the monthly payment amount, the date upon which payments start, and the number and amount of payments if paid according to schedule. Further, the form requires attachment of all court judgments, security agreements, and evidence of perfection.

Bruzzese and *Melendez* require the attorney to check the valuation of the collateral rather than accepting the creditor's statement of value. The form, however, merely requires a creditor's statement describing the collateral, with assertions regarding value and lien validity. Counsel would be well advised to go beyond the requirements of the form with respect to collateral valuation, to ensure that the

¹⁵*Id.*, at 197-199.

¹⁶*Id.*, 224 B.R. at 273, n. 30.

requirements of case law are met.

Did the Attorney Advise on Legal Consequences?

Finally, the attorney should explain the legal consequences of reaffirmation default, discuss alternatives to reaffirmation such as redemption, and ensure that the debtor is voluntarily entering the agreement without coercion. The form's "Notice to Debtor" explains that the agreement gives up the protection of the bankruptcy discharge and that the creditor may be able to take the debtor's property or wages if payment is not made. The form requires the debtor to state why she chose not to redeem and whether she was represented by counsel in the negotiations.

If the attorney performs this entire analysis, which would be aided by completion of Form B240, both the interests of the client in deciding whether to reaffirm and the duty of the lawyer to determine whether the reaffirmation imposes an undue hardship will be served. However, if after completing the form and doing a due diligence analysis the attorney cannot, in the exercise of independent judgment, execute a declaration supporting reaffirmation, she might consider refusing to affix her signature and filing the reaffirmation agreement without the declaration, thereby letting the court decide the matter.

In summary, reaffirmation agreements and attorneys' declarations are under increased judicial scrutiny. The emerging standard of care for a consumer debtor's attorney counsels a more cautious and informed approach to reaffirmation. Use of the new Form B240 should aid attorneys in discharging their duties to both the client and the court, while allowing Section 524(c) to operate as intended.