By Joseph D. Austin

Cross-Collateralization and a Debtor's Options Under § 1325(a)(5)

Nearly every bankruptcy case filed under chapter 7 or 13 will include a vehicle (or two), either in a debtor's chapter 7 statement of intentions or under a debtor's chapter 13 plan. Credit unions are a common source of financing for auto loans: They are member-based and can offer greater flexibility on loan terms.

Credit unions typically include cross-collateralization provisions in loans made to their members, and many consumers will not even realize that their loan and security agreements include cross-collateralization provisions. These provisions are sometimes referred to as dragnet, future-advance or all-indebtedness provisions. Whatever the preference in your region for terminology, a cross-collateralization provision may turn a debtor's dream purchase into a nightmare.

Simply put, cross-collateralization provisions allow consumers to use collateral from one loan to secure another debt. These provisions allow the use of a financed vehicle to secure other debt such as a credit card loan, or even another car loan. While the latter option seems duplicative and unnecessary, a creditor will be better off if it can apply equity from one vehicle loan toward a secured loan, and the better a creditor's position will be during the life of a loan and in a potential bankruptcy. The result could turn an unsecured credit card claim where a creditor often receives pennies on the dollar into a partially secured debt.

Depending on which side of the transaction you are on, cross-collateralization is often looked at as either creative financing for unqualified and risky borrowers, or an oppressive financing tactic to secure non-purchase-money obligations of the unsuspecting debtor.

To a consumer, cross-collateralization provisions are likely found as boilerplate wording at the end of a loan or security agreement and are difficult for the consumer to understand. To a creditor, the provisions might prove critical, and if a creditor does not have them in existing agreements, the creditor should consider adding them.[1] Convincingly, states across the nation are overwhelmingly enforcing cross-collateralization provisions as valid.[2]

Cross-Collateralization Provisions

Let's consider the exhibit at right to demonstrate the effect that cross-collateralization provisions have on a debtor in a chapter 13 bankruptcy. A member of a credit union finances two vehicles using both loan and security agreements that both include cross-collateralization provisions. The member obtains a car in 2013 and a truck in 2014. Due to the cross-collateralization provisions, the car loan is secured by the car and truck, and the truck loan is secured by the truck and car. Therefore, the member's debts and collateral securing each loan are shown in the exhibit.

After a short time, this member is unable to pay his debts and soon thereafter files for bankruptcy. Chapter 7 and 13 provide consumer debtors with numerous options to retain their vehicles.[3]

In a chapter 7 bankruptcy, most of a debtor's debts are discharged in exchange for the debtor relinquishing his/her nonexempt property. For a debtor in chapter 7 to keep an asset securing a debt that would normally be discharged, the debtor must reaffirm the debt.[4]

On the other hand, in chapter 13, a debtor could elect to keep his/her vehicle and pay the secured debt through the chapter 13 plan. As long as the debtor is current on his/her bankruptcy plan payments and keeps the car insured, the debtor will likely be able to keep his/her car under bankruptcy law.

However, when a debtor has two vehicles financed from a creditor and the contracts include cross-collateralization provisions as the exhibit demonstrates, the debtor's options are not as clear as they might appear under § 1325(a)(5), which provides:

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1 If allowed under state law.

2 U.C.C. § 9-204 (2000); *see In re Residential Capital LLC*, 501 B.R. 549, 615 (Bankr. S.D.N.Y. 2013) (holding that security interest "arising by virtue of an after-acquired property clause is no less valid than a security interest in collateral in which the debtor has rights at the time value is given ... no further action by the secured party — such as a supplemental agreement covering the new collateral — is required"); *see also In re Natale*, 508 B.R. 790, 801 (Bankr. D. Mass. 2014) (holding that dragnet clauses are enforceable in Massachusetts); *see also In re Stevens*, 307 B.R. 124, 128 (Bankr. E.D. Ark. 2004) (holding after-acquired property clauses as valid).

3 While this article discusses a consumer debtor's options under chapters 7 and 13, the focus of this article is on a debtor's options under § 1325(a)(5).

4 Another less common option is for a chapter 7 debtor to redeem a vehicle by paying the lender the "current replacement value of the car." The trustee must first abandon the vehicle, and the debtor must make a lump-sum payment to redeem the vehicle. This option is less likely to be used due to the financial constraints on a debtor.

Cross-Collateralization Effect

Secured Claims	Collateral Securing Each Secured Claim
Car Loan	Car Truck
Truck Loan	Truck Car

(5) with respect to each allowed secured claim provided for by the plan –

(A) the holder of such claim has accepted the plan;

(B) [the cramdown option];[5] or

(C) the debtor surrenders the property securing such claim to such holder....[6]

At times, a creditor will agree to the debtor's treatment, but if a creditor does not accept the debtor's plan, the debtor has two remaining options under § 1325(a)(5): the cramdown option or a surrender of the collateral. A creditor may wish to simply have the debtor surrender the collateral back to the creditor, which allows the creditor to resell the vehicle to a stable creditor outside of bankruptcy. The remaining option will result in the creditor having its secured claim "crammed down" in value, and the vehicle will remain property of the estate.

However, the options under § 1325(a)(5) are unclear when dealing with a debtor who has multiple loans containing cross-collateralization provisions. Before *Barragan-Flores*, which is later discussed in detail, it appears that no reported decisions have addressed a plan proposing a partial surrender and retention of collateral under chapter 13 with two loans that contain cross-collateralization provisions.

The closest case was *In re Williams* from the Fifth Circuit,[7] which involved a debtor that obtained one loan secured by multiple pieces of property.[8] Laura Williams' chapter 13 plan proposed to avoid the lien on one piece of collateral and cram down the remaining pieces of collateral.[9] She later filed a motion to modify her chapter 13 plan to return some of the collateral[10] and cram down the value on the remaining items. Williams was attempting to retain some of the collateral and surrender other pieces of the collateral — in other words, a "partial surrender." The Fifth Circuit held that § 1325(a)(5) does not permit a partial surrender while retaining other collateral and denied Williams' motion to modify. *Williams* is premised on § 1325(a)(5), which permits a debtor, when dealing with a secured claim, to either retain the collateral and pay its present value or surrender the collateral.

Circuits outside of the Fifth Circuit addressing partial surrender in the "one loan" context are currently split on the issue of allowing partial surrender under § 1325(a)(5).[11] Surprisingly, several chapter 12[12] cases have encountered multiple loans with cross-collateralization provisions. Chapter 12 of the Bankruptcy Code is modeled after chapter 13 and is nearly identical in regard to the relevant chapter 13 provisions currently at issue.[13] Various chapter 12 cases have held that debtors cannot sever cross-collateralization provisions securing multiple pieces of collateral.[14]

In re Barragan-Flores

Evolve Federal Credit Union sought to clarify *In re Williams* in a multiple-loan context and clear up the combination of options debtors had been invoking. The debtor's loans in *Barragan-Flores* were made on the basis of the example above. The debtor in *Barragan-Flores* obtained two vehicles (a car and a truck) from the credit union, and both loan and security agreements contained cross-collateralization provisions.[15]

> **Creditors ... should include clearly drafted cross-collateralization provisions to strengthen security interests when multiple loans or additional credit is contemplated.**

The debtor's chapter 13 plan proposed to retain the truck and surrender the car, relying on 11 U.S.C. § 1325(a)(5).[16] Therefore, the debtor was proposing a partial surrender of the collateral due to the credit union's cross-collateralization provisions.

The credit union objected to the debtor's chapter 13 plan and argued that since both of the credit union's contracts contained cross-collateralization provisions, each of the credit union's secured claims were secured by multiple vehicles. The credit union argued that the debtor must either retain (and pay for) or surrender both the car and truck in order to satisfy the plan requirements of § 1325(a)(5), and that any partial surrender would effectively sever the bargained-for cross-collateralization provisions contained in the credit union's loan and security agreements.

The debtor argued that since the credit union held two allowed secured claims (one for each vehicle loan), the debtor had an option under § 1325(a)(5) with respect to each allowed secured claim, and the bankruptcy court agreed. The bankruptcy court distinguished *In re Williams* because the debtor in *Williams* had only one loan and one secured claim, while the debtor in *Barragan-Flores* had two loans with two secured claims, and the debtor could choose two options for each of the credit union's secured claims. Therefore, the bankruptcy court allowed the debtor to choose different options under § 1325(a)(5) for the car and truck.

The credit union appealed the bankruptcy court's order confirming the debtor's chapter 13 plan to the U.S. District Court for the Western District of Texas, which reversed the bankruptcy court, relying heavily on the reasoning from *In re Williams* and similar chapter 12 decisions. The district court analyzed each secured claim separately and what collateral secured each claim, and determined that

5 The cramdown option allows for a debtor to confirm his chapter 13 plan over a creditor's objection by paying the present value of the collateral over the life of the plan.

6 11 U.S.C. § 1325(a)(5) (emphasis added).

7 *In re Williams*, 168 F.3d 845 (5th Cir. 1999).

8 *Id.* at 846. The collateral included a set of law books, camera, saxophone and various electronics.

9 *Id.*

10 A set of law books, television and gold chain.

11 *Compare, e.g., United States v. White*, 340 B.R. 761, 766 (E.D.N.C. 2006) (allowing partial surrender); *In re McCommons*, 288 B.R. 594, 596-97 (Bankr. M.D. Ga. 2002) (same), *with In re Lemming*, 532 B.R. 398, 406 (Bankr. N.D. Ga. 2015) (rejecting partial surrender); *In re Elkins*, No. 04-67961, 2005 WL 4030041, at *3 (Bankr. S.D. Ohio Aug. 16, 2005) (same).

12 Chapter 12 is for family farmers and fishermen to file for bankruptcy.

13 *In re Williams* (describing 11 U.S.C. §§ 1225(a)(5) and 1325(a)(5), § 1225(a)(5) "is modeled after and is identical to its Chapter 13 counterpart, codified at 11 U.S.C. § 1325(a)(5)"); *see In re Kerwin*, 996 F.2d 552, 559 (2d Cir. 1993) ("Moreover, while § 1225's legislative history is quite sparse, the legislative history of § 1325 — on which § 1225 was patterned...."); *see* H.R. Conf. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5246, 5249 ("This new chapter is closely modeled after existing Chapter 13.").

14 *In re Clark*, 288 B.R. 237, 241-42 (Bankr. D. Kan. 2003) (denying chapter 12 plan that proposed to split up collateral secured under cross-collateralization provisions); *In re Chickosky*, 498 B.R. 4 (Bankr. D. Conn. 2013) (holding that debtors could not use the plan-confirmation process in order to eliminate cross-collateralization rights of lender that funded their farming operations; *In re Heath*, 483 B.R. 708, 709 (Bankr. E.D. Ark. 2012) (denying confirmation of chapter 12 plan that would modify debtor's lender's rights by severing cross-collateralization of lender loans).

15 The cross-collateralization provisions stated as follows: "Property securing other loans you have with us also secures this loan, unless the property is a dwelling."

16 The credit union filed two separate proofs of claim: one for the car and one for the truck.

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each loan was clearly secured by two vehicles. As a result, the debtor would have to surrender all collateral securing each loan — the car and truck — and that surrendering only the car was a partial surrender under § 1325(a)(5) and impermissibly severed the credit union's bargained-for cross-collateralization provisions.

The district court held that just "like the debtor in *In re Williams* who had to either cram down or surrender all of the collateral securing the loan, [the] Debtor must either cram down or surrender all of the collateral securing [the two loans]."[17] The treatment that the debtor proposed could not be done unless the "cross-collateralization clauses were somehow set aside."[18]

Debtor's counsel appealed the district court's decision, and the appeal is currently before the Fifth Circuit.[19] The district court's decision is only binding in the Western District of Texas but, depending on the Fifth Circuit's decision, could impact all chapter 13 cases involving multiple loans containing cross-collateralization provisions and send ripple waves to debtor attorneys in regard to a debtor's options when filing a chapter 13 plan. With cross-collateralized vehicles, the district court's opinion will require debtors to either retain (and pay for) or surrender both vehicles. Consumers might find this difficult, as this statutory construction takes away flexibility in a chapter 13 plan. Debtors are often looking to surrender a vehicle in order to reduce their debt while keeping one vehicle for continued use.

Moving Forward

Consumers could diversify lenders to avoid this result. However, consumers are not likely to fully comprehend the consequences of cross-collateralization provisions at the time of signing for a loan and security agreement, and it is beneficial for consumers to finance from the same lender for the convenience of obtaining additional credit and favorable lending terms.

Creditors moving forward should include clearly drafted cross-collateralization provisions to strengthen security interests when multiple loans or additional credit is contemplated. If a creditor has bargained for multiple pieces of collateral, case law is trending toward an approach that debtors under chapter 13 are not able to do a partial surrender of collateral. Therefore, a debtor will either need to pay the present value for all collateral securing a loan or surrender all pieces of collateral securing such loan. Hopefully, in affirming or reversing, the Fifth Circuit will provide guidance across the country on this important issue. abi

17 *In re Barragan-Flores*, 585 B.R. 397, 401 (W.D. Tex. 2018).
18 *Id.* at 402, n.4.
19 Currently, the appeal has been fully briefed and the parties are awaiting an order or date setting oral arguments. *In re Barragan-Flores*, 585 B.R. 397, 401 (W.D. Tex. 2018), *appeal docketed*, No. 18-50420 (5th Cir.).