Chapter 7 Bankruptcy – How To Think About Auto Loans

by Tim Condon (www.leapautoloans.com)

In the past few years the credit landscape has changed dramatically, and auto lending is no exception. Prior to the credit crisis that began in 2007, many consumers emerging from bankruptcy were able to obtain financing for another vehicle. The current credit climate makes it much more difficult to get credit approval for an auto loan post-bankruptcy. Therefore, decisions made in bankruptcy regarding auto debt have become increasingly important.

The debtor basically has three options regarding auto debt in a Chapter 7 bankruptcy: reaffirmation of the debt, surrender of the vehicle, or redemption.

1. **Reaffirmation** – Debtor reaffirms the terms of the auto debt to avoid surrender of the vehicle. Although common, it is often not in the borrower's best financial interest to reaffirm.
2. **Surrender** – Debtor turns the vehicle in to the lender to resolve the auto debt.
3. **Section 722 Redemption** – Debtor pays fair market value for the vehicle and the deficiency balance is waived. This alternative is not usually pursued as the debtor has no money.

Reaffirmation of the auto debt is done about half the time. Almost all of the remaining population is surrendered. Very few debtors redeem the vehicle for the obvious reason that they do not have the money.

If the issue of having the funds can be resolved, however, it very often makes economic sense to redeem the vehicle at fair market value. Most often in the early stages of an auto loan, the vehicle value depreciates faster than the loan amortizes. Therefore, at the time of a bankruptcy filing, the outstanding auto debt is frequently more than 150% of the vehicle value – sometimes much more. In a typical bankruptcy situation, the outstanding loan amount is $17,000 and the vehicle is worth $11,000. If a debtor reaffirms the debt in this example, he would unnecessarily take on an additional $6,000 of debt. So even though the stated interest rate on the loan may be low, the effective rate going forward is extremely high due to the amount that the loan is "underwater" (i.e. amount owed exceeds vehicle value.)

Things to consider when evaluating auto debt options:

1. What is the vehicle worth relative to the loan amount?
2. Is the vehicle in good shape and likely to last while the debtor re-establishes credit?
3. What are the debtor's alternatives in obtaining another vehicle?
4. Is there a way to get the funds to redeem the vehicle?
5. Is the post-bankruptcy car payment affordable?

The debtor's alternatives to keeping the vehicle are an important consideration. There are many "buy-here, pay-here" car lots making exorbitant profit in this economy selling vehicles under installment contracts to people emerging from bankruptcy. Because the debtors are unable to get credit from more traditional sources, they are often paying extreme markups on another vehicle, and they are right back in the same situation – far underwater on their car loan.

While sometimes difficult to find and qualify, there are lenders/leasing companies who will provide financing for a 722 Redemption. In our prior example, the outstanding loan amount would be reset from $17,000 to $11,000 (plus some transaction costs), and the debtor would be in a far better situation.

The following table summarizes the debtor's options, assuming there is an ability to finance the redemption decision and the borrower can get a different car if needed:

	Vehicle In Good Condition	Vehicle In Bad Condition
Vehicle Value < Outstanding Debt	722 Redemption	Surrender
Outstanding Debt < Vehicle Value	Reaffirmation	Surrender or 722 Redemption Depending on Vehicle Condition

A little clear thinking can save thousands of dollars in a difficult situation.