What Creditors Should Know About Co-Debtors in Chapter 13 Consumer Bankruptcies

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Auto lenders must have a basic familiarity with the consumer bankruptcy process. An essential component of any consumer bankruptcy is the automatic stay. The "automatic stay" is the name of the injunction that arises automatically upon the filing of any bankruptcy. The stay prevents lenders from, among other things, seeking to collect on a debt that arose prior to the bankruptcy filing. A lender who willfully violates the automatic stay may be liable to the debtor for damages, including punitive damages.

In a Chapter 13 consumer bankruptcy, the automatic stay extends to co-debtors. "Co-debtors" include co-borrowers and co-signors of consumer debts. Therefore, the "co-debtor stay" extends the protections of the automatic stay (and the liability for violations of the stay) to co-borrowers and co-signors of consumer debts, even though the co-borrower or co-signor has not filed for bankruptcy.

Due to the prevalence of co-signors in vehicle lending, the co-debtor stay is a key concept in consumer bankruptcies involving auto finance.

The co-debtor stay prevents a creditor from acting, or commencing or continuing any civil action, to collect all or part of a debt from the co-debtor. For example, let's assume that a daughter needs a car before moving away to college. Because she does not have an established credit history, her dad co-signs her retail installment contract. Six months later, dad files for Chapter 13 bankruptcy. At the same time, daughter stops making payments on the loan. The co-debtor stay prevents the lender from repossessing the vehicle because dad is in bankruptcy.

Note, however, that a lender may accept voluntary payments from a co-debtor despite the co-debtor stay. In our example, the auto lender could accept a voluntary payment from the daughter even after her dad filed for bankruptcy.

When accepting voluntary payments from a non-filing co-debtor, a lender may want to obtain the written consent of the debtor's attorney, the bankruptcy trustee, and the co-debtor to an order permitting the lender to accept voluntary payments from the co-debtor. This reduces the risk that the debtor will later argue that co-debtor payments were coerced.

Auto lenders can seek to "lift," i.e. legally remove, the co-debtor stay during the pendency of the Chapter 13 bankruptcy by filing a motion with the bankruptcy court. Lenders may seek to lift the co-debtor stay for the following reasons: (1) the debtor's bankruptcy plan does not propose to pay the debt; (2) the co-debtor received the benefit of the debt instead of the debtor; or (3) the creditor's interest would be harmed beyond repair by continuation of the automatic stay.

In our example, the lender may want to file a Lift Stay Motion and argue that the daughter received the entire benefit of the vehicle loan because: the daughter is the sole operator of the vehicle, the vehicle moved to another state with the daughter when she went to college, and her dad has a separate vehicle for his personal use.

If an auto lender does not "lift" the automatic stay, and the bankruptcy is not otherwise dismissed or converted to a Chapter 7 or Chapter 11 bankruptcy, the debtor will receive a discharge upon completion of plan payments, usually within three to five years. The discharge releases the debtor from personal liability for all debts provided for by the bankruptcy plan or disallowed. At this time, the co-debtor stay also is lifted. However, unlike the debtor, a co-debtor remains personally liable on the entire debt and the lender may now enforce its rights against the co-debtor.

Even after the bankruptcy case is closed and the debtor has received a discharge, auto lenders in community property states should be cautious of pursuing payment from a non-filing spouse of a former Chapter 13 debtor. A court may consider this to be a violation of the discharge injunction (i.e. the injunction which replaces the automatic stay upon entry of the discharge order) if the payments source arguably is community funds. This is true regardless of whether the non-filing spouse is a co-debtor.

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