

# Bankruptcy 201

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## Four Ways to Deal With a Secured Claim in Chapter 13

- Cure a pre-bankruptcy payment default (*e.g.*, pay the mortgage arrearage over time) and maintain ongoing mortgage payments while the automatic stay and a repayment plan are in effect
- Remove the lien using an avoidance provision
- Modify the terms and pay the claim in full over the plan term
- Do nothing

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## Bankruptcy Discharge and Mortgages

- Chapter 7: discharge eliminates personal liability of debtor (no deficiency claim), but leaves enforceable lien.
  - Johnson v. Home State Bank, 501 U.S. 78 (1991)
- Chapter 13: same except that debtor's personal liability on mortgage not eliminated if debtor's plan treats mortgage claim under § 1322(b)(5) by providing for cure of default or maintenance of payments. 11 U.S.C. § 1328(a)(1)

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## Secured Claims in Bankruptcy

- § 506(a) - creditor's "allowed secured claim" is limited to value of collateral (undersecured claim may be bifurcated into its secured and unsecured portions)
- § 506(d) - lien is void to the extent that it secures a claim which is not an allowed secured claim
- Strip down not permitted on secured claims in chapter 7 proceedings

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## Anti-modification Provision



Section 1322(b)(2) – The plan may “modify the rights of holders of secured claims, ***other than a claim secured only by a security interest in real property that is the debtor’s principal residence***, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims”

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## Parsing the Language



Section 1322(b)(2) – The plan may “modify the rights of holders of secured claims, other than a ***claim secured*** only by a security interest in real property that is the debtor’s principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims”

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## Upside Down Homes



Value of Home: \$120,000  
Amount due on First Mortgage: \$125,000  
Amount due on Second Mortgage: \$15,000  
Total Amount of debt: \$140,000

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## Underwater Mortgages



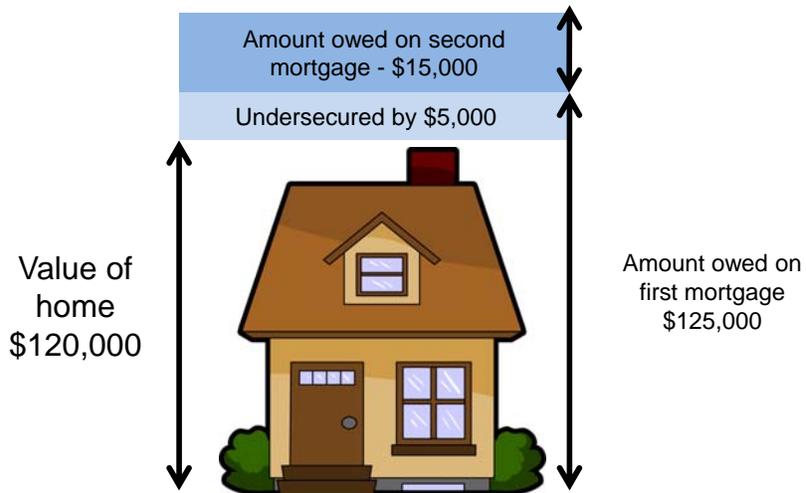
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## Underwater Mortgages



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## Underwater Mortgages



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## Stripping Off Wholly Unsecured Mortgages

- *Nobelman v. American Sav. Bank*, 508 U.S. 324 (1993)
- Supreme Court noted that it is “correct [to] look[ ] to § 506(a) for a judicial valuation of the collateral to determine the status of [a creditor]’s secured claim.”
- Creditor in *Nobelman* was a “‘holder’ of a ‘secured claim,’ because [the debtors]’ home retain[ed] \$23,500 of value as collateral.”

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## Stripping Off Wholly Unsecured Mortgages

- Typically 2nd or 3rd mortgages
- Value of senior liens exceeds property value so that mortgage is “wholly unsecured”
- Security interest rendered void
- Amount due treated as unsecured claim in chapter 13

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## Doing the Calculations

- If total of all **senior liens** equal or exceed property's **value**, junior lien creditor has no allowed secured claim
- Exemptions not considered
- Effect of first lien loan mod with principal reduction
- Overlooked items:
  - Statutory tax liens (timing issues)
  - Prepayment penalties
  - Interest subsidy recapture
  - “Silent seconds”

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## OTHER PERMISSIBLE MODIFICATIONS

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## Parsing the Language



Section 1322(b)(2) – The plan may “modify the rights of holders of secured claims, other than a claim secured **only** by a security interest in real property that is the debtor’s principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims”

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## Additional Security

- Anti-modification provision does not apply if debt secured by additional property (e.g., furniture, appliances, cars, etc.)
- Definition of “debtor’s principal residence” added in 2005, includes “incidental property” - § 101(13A)
- “Incidental property” defined to include: rents, fixtures, escrow funds, insurance proceeds – § 101(27B)

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## Parsing the Language



Section 1322(b)(2) – The plan may “modify the rights of holders of secured claims, other than a claim secured only by a security interest in **real property *that is*** the debtor’s principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims”

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## Multi-family Buildings

- Modification permitted when other real property, such as rental units, is part of security interest



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## Parsing the Language



Section 1322(b)(2) – The plan may “modify the rights of holders of secured claims, other than a claim secured only by a security interest in **real property** that is the debtor’s principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims”

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## Mobile Homes

- Loans on mobile homes that are considered personal property under state law are not subject to the anti-modification provision



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## Short-term Loans

- Section 1322(c) exception to anti-modification provision for short term loans, often balloon payment loans
- Applies to mortgages having final payment due during life of chapter 13 plan
- May be modified, but must be paid during plan
- Potential help for heirs dealing with reverse mortgages - *In re Griffin*, 489 B.R. 638 (Bankr. D. Md. 2013)(reverse mortgage that was accelerated prepetition may be modified)

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## Benefits of Bankruptcy Even When Mortgage Cannot be Modified

- Stay foreclosure proceedings
- Deaccelerate loan and cure defaults
- Judicial lien avoidance
- Bring predatory lending claims
- Avoid transfers in foreclosure rescue scams

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## Cure and Maintain

- Section 1322(b)(5)
- Mortgage arrearage, including reasonable pre-petition foreclosure costs, can be cured within “reasonable time”
- Plan shall also provide for “maintenance of payments” while case pending
- ALL payments are made under plan, even if debtor disburses ongoing maintenance payments
- Chapter 13 can be filed and mortgage default cured even if debtor not eligible for discharge due to prior bankruptcy discharge

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## **VOLUNTARY LOAN MODIFICATION PROGRAMS AND BANKRUPTCY**

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## Bankruptcy and HAMP

- Combining options for home retention
- Future monthly mortgage payments set at 31% of gross household income
- Discharge of most unsecured debts
- Bankruptcy deals with back-end debt to income ratio problem (often exceeds 60% after HAMP mods)
- Potential to void or strip off other liens

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## Past Discharge Not an Obstacle

- What are servicers afraid of?
  - violation of discharge order despite section 524(j)
  - general hostility due to less leverage over debtor in collection
  - only an issue for chapter 7
- Former debtor who obtained chapter 7 discharge (now has no personal liability on note) is eligible for HAMP even if no reaffirmation.
  - MHA Handbook Ch. II §§ 1.2, 10.1
  - Fannie Mae Single Family Servicing Guide § 609.01
  - Freddie Mac Single Family Servicer Guide § C65.7.1
  - HUD Mortgagee Letter 2008-32

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## Required Change to Modification Agreement

- If prior discharge and no reaffirmation, must insert language in Modification Agreement:

“I was discharged in a Chapter 7 bankruptcy proceeding subsequent to the execution of the Loan Documents. Based on this representation, Lender agrees that I will not have personal liability on the debt pursuant to this Agreement.”

- MHA Handbook Ch. II §§ 1.2, 10.1
- Fannie Mae Single Family Servicing Guide § 609.03.06
- Freddie Mac Single Family Servicer Guide § C65.2

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## Reaffirmation Requirements

- Reaffirmation must be entered into before entry of discharge
- Majority view is that bankruptcy court does not have authority to vacate discharge in order to permit a reaffirmation agreement made after entry of discharge to be enforceable

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## Past Discharge Not an Obstacle

- *In re Bellano*, 456 B.R. 220 (Bankr. E.D.Pa. 2011) (refusing to reopen bankruptcy to file reaffirmation involving HAMP modification based in part on HAMP directive)
- *In re Tincher*, 2011 WL 2650569, at \*3 (Bankr.D.S.C. July 5, 2011) (“This directive makes clear that debtors who file bankruptcy were intended to be eligible for HAMP post-bankruptcy, without being required to reaffirm their mortgage debt.”)

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## Borrowers *in* Bankruptcy

- Borrowers in active chapter 7 or 13 bankruptcy cases are eligible for HAMP at the servicer’s discretion in accordance with investor guidelines
- “Notwithstanding the foregoing,” these borrowers **must** be considered for HAMP if borrower, borrower’s attorney, or trustee submits request
- Servicers are not required to solicit these borrowers proactively for HAMP

– MHA Handbook Ch. II, § 1.2

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## Borrowers in Bankruptcy

- **Fannie Mae HAMP:** Borrowers in active bankruptcy cases are eligible for HAMP at the servicer's discretion
  - Fannie Mae Single Family Servicing Guide § 609.01
- **Freddie Mac HAMP:** Borrowers in active chapter 7 or 13 bankruptcy cases must be considered for HAMP if borrower, borrower's attorney, or trustee submits request
  - Freddie Mac Single Family Servicer Guide § C65.7.1

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## Filing Bankruptcy During a Trial Plan

- Borrowers who are currently on TPP and file for bankruptcy may not be denied a permanent modification on basis of filing
- Servicer and its counsel must work with borrower to obtain court approval of modification
- TPP may be extended up to total of five months if needed to obtain court approval
  - MHA Handbook Ch. II §§ 1.2, 8.5
  - Fannie Mae Single Family Servicing Guide § 609.03.07
  - Freddie Mac Single Family Servicer Guide § C65.7.1

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## HAMP and Chapter 13

- Servicers must not object to confirmation of chapter 13 plan, move for relief from the automatic stay, or move to dismiss the chapter 13 case on basis that borrower has paid only the TPP payments rather than scheduled payments
  - MHA Handbook Ch. II, § 8.6
  - Freddie Mac Single Family Servicer Guide § C65.7.1
- Servicer may not convert mortgage to permanent HAMP modification unless the mortgage is “released from the bankruptcy plan”
  - Freddie Mac Single Family Servicer Guide § C65.7.1

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## Bankruptcy and HAMP

### Court Approval:

- Servicer and its counsel must work with borrower or borrower’s counsel to obtain any court and/or trustee approvals required in accordance with local court rules and procedures.
  - MHA Handbook Ch II, 8.5
- *In re Smith*, 409 B.R. 1 (Bankr. D. N.H. 2009) (finding that motion for approval of loan mod. does not present court with a case or controversy unless filed in connection with proceedings for stay relief, plan confirmation, or plan modification)

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## Bankruptcy and HAMP

- Other bankruptcy loan mod issues
  - Interaction with automatic stay
  - Effect on plan, schedules in chapter 13
  - Court approval
  - Can propose plan based on hoped-for modification of payment of 31% of debtor's gross monthly income (or as pre-confirmation adequate protection)
    - *In re Arizmendi*, 2011 WL 2182364 (Bankr. S.D.Cal. May 26, 2011)(finding that TPP payments provided sufficient adequate protection even though contract interest not being paid)
  - Keep court informed of what is happening with loan modification requests
  - Binding effect of plan confirmation order

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## Bankruptcy and HAMP

### Can debtor cure a HAMP default in bankruptcy?

- Debtor on TPP is current if all payments made no later than 30 days after final payment due
  - Should be able to file chapter 13 cure plan if default
- Debtor on permanent mod loses “good standing” if 3 monthly payments unpaid on last day of third month
  - HAMP mod enforceable as new contract and can be cured in chapter 13
  - Cure may not reinstate “good standing” and incentives, but perhaps section 525(a) applies
  - *In re Weatherell*, 2010 WL 3938225 (Bankr. D.Vt. Sep 29, 2010)(permitting cure of loan mod. default)

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## Bankruptcy and Loan Mods

### Protection of Automatic Stay

- Under Bankruptcy Rule 4004(c)(2), a court may defer entry of discharge in chapter 7 case for 30 days on motion by debtor, and may extend further to date certain on motion filed within 30-day period
- Under § 362(c)(2), automatic stay continues until earliest of: time case closed; time case dismissed; time discharge granted
- *In re Roderick*, 425 B.R. 556 (Bankr. E.D. Cal. 2010) (continuation of stay to negotiate reaffirmation in context of HAMP mod granted under Rule 4004(c))

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## Recent Bankruptcy Loan Mod Decisions

- *In re Dumbuya*, 428 B.R. 410 (Bankr. N.D. Ohio 2009) (modification enforceable by effect of plan confirmation order; irrelevant that creditor did not sign it)
- *In re Pico*, 2011 WL 3501009 (Bankr. S.D. Cal. Aug 09, 2011) (finding that debtor and servicer intended that HAMP Loan Modification Agreement be binding once debtor signed, notarized and returned it to servicer)
- *In re DeLaFuente*, 430 B.R. 764 (Bankr. S.D. Tex. 2010) (contempt sanctions imposed upon creditor for post-discharge collection efforts contrary to plan that cured default)

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## Recent Bankruptcy Loan Mod Decisions

- ***In re Jones***, 2010 WL 358494 (Bankr. E.D.N.C. Jan 21, 2010)(stay relief denied in part based on servicer's actions in stating that modification would be honored even if received past deadline; receiving and accepting payments under unsigned agreement and then, after several months, declaring a default and not recognizing agreement)
- ***In re Cruz***, 2011 WL 285229 (Bankr. D. Mass. Jan. 26, 2011) (court issues prelim. injunction enjoining foreclosure sale pending HAMP review, recognizing good faith and reasonable dealing claim)

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## Timing of Loan Mods

### **Mods *Before* Bankruptcy:**

- Pros:
  - Does not affect eligibility for mods
  - Debtor will remain eligible for permanent HAMP mod even if bankruptcy filed during trial period
- Cons:
  - Event of default under non-HAMP mods when bankruptcy later filed?
  - No help with “total” or “back-end” debt ratio
  - No help with subordinate liens
  - Potential DOI income if principal reduction and no bankruptcy tax exception in later bankr. case

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## Timing of Loan Mods

### Loan Mods *During* Bankruptcy:

- Pros:
  - Stops foreclosure while mod processed
  - Makes Chapter 13 plan feasible
  - Deals with subordinate liens (stripoff)
  - Tools for getting info on HAMP application (Rule 2004 exam, RESPA Request for Information)
  - Potential waiver of trial period
- Cons:
  - Non-HAMP mod eligibility?
  - Need to deal with servicer fears about automatic stay
  - New default servicer/law firms involved
  - May need court approval or plan modification

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## Timing of Loan Mods

### Mods *after* Bankruptcy:

- Pros:
  - Does not affect eligibility for mods
  - No reaffirmation in chapter 7 required for HAMP, FHA, Fannie/Freddie mods
  - May avoid DOI income
- Cons:
  - Servicers ignore guidelines and deny mod if no reaffirmation

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