

PROCEDURES AND TECHNIQUES IN DEALING WITH WHOLLY UNDERSECURED MORTGAGES IN A CHAPTER 13 BANKRUPTCY PROCEEDING

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VALIDITY vs VALUE

Presently, in this mortgage meltdown dilemma, bankruptcy attorneys are regularly confronted with situations wherein their Debtors have purchased residential property in the relatively recent past employing methods similar to the prevalent 80/20 financing that has been a major contributing factor in the undersecured mortgage morass. In evaluating these particular problems during client intake interviews, it is usually discovered that because of the drastic diminution of real estate values in the recent past, these 20% second mortgages are now wholly undersecured. In properly advising their clients, bankruptcy attorneys need to be aware of the differing procedures and techniques in dealing with the cram down and/or avoidance of wholly undersecured mortgages. Indeed, the various federal jurisdictions have varying procedures and requirements when it comes to avoiding or cramming down a wholly undersecured second mortgage.

In June of 2008, the United States Courts of Appeals for the Third Circuit found that the only method for avoiding a wholly undersecured mortgage was by adversary proceeding. In re Janica Mansaray-Ruffin, 530 F.3d 230 3rd Cir. (2008). However, it should be noted, that the Mansaray-Ruffin Court was presented with an issue attacking the validity of the mortgage rather than an argument pertaining to the value

of collateral. In *Mansaray-Ruffin*, the Debtors contended that a series of Truth In Lending Act violations invalidated the mortgage. Although the Chapter 13 Plan filed in the *Mansaray-Ruffin* case indicated that the Debtors would file an adversary proceeding to avoid the junior mortgage, no such adversary proceeding was ever filed. Since the validity of the mortgage rather than the value of the collateral was the issue presented to the *Mansaray-Ruffin* court, the court proceeded pursuant to Federal Rules of Bankruptcy 7001(2) which dictates that “a proceeding to determine the validity, priority, or extent of a lien or other interest in property, other than a proceeding under Rule 4003 (d) requires an adversary proceeding.” See also, *In re Kemp*, 391 B.R. 262 (Bankr. D. N.J. 2008)

The court, in *Mansaray-Ruffin*, noted at the outset of the case that “it must be noted that bankruptcy has traditionally afforded special status to liens, allowing them to pass through bankruptcy unaffected”. *In Re: Long v. Bullard*, 111 U.S. 617, (1886).

IN PERSONAM vs. IN REM

The *Mansaray-Ruffin* court further opined “the general rule is that liens passed through bankruptcy unaffected. A bankruptcy discharge extinguishes only “in personam” claims against the Debtor, but generally has no effect on an “in rem” claim against the Debtor’s property. For a Debtor to extinguish or modify a lien during the bankruptcy process, some affirmative step must be taken towards that end. Unless the Debtor takes appropriate affirmative action to avoid a security interest in property of the estate, that property will remain subject to the security interest following confirmation. *In Re: Cen-Pen Corp. v. Hanson*, 58 F.3d 89 (4TH cir. 1995).

While Bankruptcy Rule 4003 (d) allows **judicial lien avoidance** by motion, since it deals with a Debtor's claim to exemptions and is a judicial lien rather than a consensual lien. However, Bankruptcy Rule 7001 (2) requires that **consensual liens** such as a mortgage can only be avoided by adversary proceeding, noting that proper notification, via a complaint and summons, is required so that a lien holder may be apprised of such avoidance action as it affects the lien status. "We can not defer to a Chapter 13 Confirmation Order on Res Judicata grounds if it would result in a denial of due process in violation of the 5th Amendment of the United States Constitution". In re Linkous, 990 F.2d 160, "4th Cir. (1993). Thus, the Mansaray-Ruffin court opined that the basic fundamental notions of procedural due process can not lead to a situation where a creditor/claimant, who has had no sufficient notice of a bankruptcy proceeding or reorganization can not and should not have their claim extinguished in a "settlement thereto". Further, the fact that a creditor possessed actual knowledge of a pending bankruptcy proceeding in which its rights may be affected does not substitute the requirement that an adversary proceeding be conducted with a complaint and summons served upon the creditor, thus providing sufficient knowledge and the due process requirement.

Similar due process arguments have been made in other circuit court opinions regarding controversial tactics used by Chapter 13 Debtors dealing with their student loans. Where some Debtors have attempted to have either the entire amount or a portion of their student loans discharged by providing for such treatment in their Chapter 13 Plan and then later arguing, after discharge, that the proper serving of the Plan on the student loan creditor was sufficient notice to the creditor and that the

ensuing discharge is a binding determination by the bankruptcy court that said student loan had in fact been “discharged by declaration”. However, the Court in In re Banks, 299 F.3d 296 (4th Cir. 2002) held that “the Debtor’s failure to initiate an Adversary Proceeding, complete with complaint, summons, and service of process required by rules 7003 and 7004 overrode § 1327’s finality provision. The court explained, we agree a bankruptcy court confirmation order generally is afforded a preclusive effect but we can not defer to such an order if it would result in a denial of due process in violation of the 5th Amendment to the United States Constitution.”

Within the Massachusetts jurisdiction, in a recent case decided by Judge Feeney, In re Pelosi, 382 T. R. 582, decided on February 21, 2008, Judge Feeney held that in seeking to avoid a wholly unsecured lien, the Court held that a **motion** was the proper pleading and that a majority of courts have addressed this issue and concluded that avoidance can be accomplished through a Chapter 13 Plan or by motion. See also In re Yekel, No. 305L47107-TMB13, 2006 WL 2662849, *3 (Bankr. D. Or. Sept. 14, 2006).

In the Mansaray-Ruffin case, the dissenting opinion noted that even though the rules of Bankruptcy procedure had been violated, in that the plaintiff did not seek to avoid the lien through an adversary proceeding process, the dissenters felt that due process had been met given the proper notice of the Chapter 13 Plan of Reorganization and motions served on the creditor.

Thus, the careful Chapter 13 practitioner should carefully analyze the issue at hand. Are we attempting to avoid a junior mortgage because there is no value of collateral or are we seeking to rescind a mortgage alleging that it is statutorily defective? Regarding the

former, the practitioner may proceed by motion, however, regarding the latter, Federal Bankruptcy Rule 7001 (2) requires an adversary proceeding complete with a complaint and service by summons.

PRACTICAL TIPS FOR AN EFFECTIVE PRACTICE

In order to avoid future problems regarding your client, title to the subject property and future complications at the Registry of Deeds, some simple rules to follow should eliminate these particular problems.

1. Accepting that wholly unsecured mortgages may be avoided by motion, the attorney should be particularly careful regarding the parties to be served. When dealing with corporations, local rules require that the president and or treasurer of the corporation receive notice of the motion to avoid lien.
2. In order to overcome any later challenges to the validity of service, the careful practitioner should serve all interested parties by certified mail, return receipt requested. This will provide the file with adequate backup regarding an accusation of defective service.
3. Regarding the procedure with which to effectively avoid a wholly unsecured mortgage under 11 U.S.C. § 506 and 11 U.S.C. § 1322(b) (2), the practitioner should draft a plan that is “idiot proof”. The plan should articulate in great detail the Debtor’s intention to avoid the wholly unsecured mortgage in its entirety. The plan should articulate by book and page the recording information pertinent to the wholly unsecured mortgage that is being avoided. Further, verbiage to the effect that the successful completion of the Chapter 13 Plan and the entry of discharge regarding the Debtor will be sufficient to avoid the wholly unsecured mortgage. (See Example 1 included)

4. The careful practitioner should not create a plan or incorporate in its motion to avoid a wholly unsecured mortgage, language that would require the mortgagee to provide the recordable documents upon completion of the Chapter 13 Plan. In light of the current situation regarding mortgage lenders, the practitioner should avoid having to rely upon third parties for recordable documents at the conclusion of the case.
5. A better approach to this problem is to articulate clearly in the Chapter 13 Plan, and also request that the Chapter 13 Trustee incorporate appropriate language into the confirmation order, verbiage to the effect that the successful completion of the Chapter 13 Plan and the entry of a discharge, along with a clerk's certificate attesting to the same, shall be sufficient for recording at the Registry of Deeds. (See example 2 included)

MODIFYING MORTGAGES

A homestead mortgage in a single family residence, secured only by the single family residence, is not a modifiable mortgage under § 1322 (b) (2). However, if the homestead mortgage entails other collateral, with real value, this will be enough to remove the protections of 11 U.S.C. § 1322 (b) (2). Homestead mortgages on multiunit buildings in which the Debtor has a residence are also modifiable mortgages not subject to the protection of 11 U.S.C. § 1322(b) (2). Topically, junior mortgages without real collateral are not subject to the protections of § 1322 (b) (2) and are able to be avoided in their entirety. The theory being that a mortgage must have “some security interest” in order to defeat the status of a wholly unsecured mortgage. One of the leading cases in this jurisdiction, and a case containing a well written analysis of mortgage modification pursuant to 11 U.S.C. § 1322 (b) (2) is Judge Boroff’s decision, written for the Bankruptcy Appellate Panel, in the case of In re Mann, 249 B.R. 831 (1st Cir. BAP 2000). Indeed, Judge Feeney in the Pelosi case decided on February 21, 2008, In Re Pelosi, 382 B.R. 582 (2008) referred to the Mann case as most illustrative regarding the issue of 11 U.S.C. § 1322 (b) (2) and 11 U.S.C. § 506(a). In the Pelosi decision, quoting from the Mann case, Judge Feeney writes:

“We agree with the Third and Fifth Circuit Courts Appeals, the Ninth Circuit Bankruptcy Appellate Panel, and the several bankruptcy and districts [sic] courts making up the majority view. Pursuant to § 506(a) and § 1322(b) (2), and notwithstanding the

antimodification provision in the latter, Chapter 13 plans may void residential real property liens that are wholly unsecured. We believe that a literal reading of § 1322(b) (2) and § 506(a) mandates this result and that our view is congruent with the Nobelman decision which relegated the role of the antimodification provision of § 1322 (b) (2) to claims first made subject to § 506(a) treatment. We decline to read Nobelman as mandating better rights for unsecured creditors holding a document purporting to be residential real property mortgage than for unsecured creditors without. We find unwarranted the argument that the burden of asset appraisal or the risk of bankruptcy abuse are beyond a court's ability to carry out its responsibilities. Neither concern justifies elevating one group of unsecured creditors over another or denying to Debtors a remedy intended by Congress for Chapter 13 Debtors. Any interpretation of the Bankruptcy Code which relies on a suspension of reality deserves to be subjected to a significant level of skepticism. Here, the bankruptcy judge was unable to find any collateral value for the Bank's mortgage lien. Accordingly, he ruled that the Bank enjoyed only the rights of a holder of an unsecured claim. Our reading of the Bankruptcy Code supports the bankruptcy judge's ruling. And we do not believe that the Congress intended otherwise."

In re Mann, 249 B.R. 831 (1st Cir. BAP 2000)

Again, quoting from Judge Feeney in *Pelosi* ..., "Since the decision in *Mann*, the Second, Sixth, Ninth and Eleventh Circuits have joined the Third and Fifth Circuits and the Ninth Circuit Bankruptcy Appellate Panel in adopting the majority position. See *Zimmer v. PSB Lending Corp.* (*In re Zimmer*), 313 F. 3d 1220 (9th Cir.2002);

Lane v. Western Interstate Bancorp (In re Lane) 280 F. 3d 663 (6th Cir. 2002); Pond v. Farm Specialist Realty (In re Pond), 252 F.3d 122 (2nd Circuit. 2001) Tanner v. FirstPlus. Inc. (In, re Tanner), 217 F. 3d 1357 (11th Cir. 2000). But see Am. Gen. Fin., Inc. v. Dickerson (In re Dickerson), 222 F.3d 924, 926 (11th Cir. 2000) (following Tanner because the panel bound by it but stating: “[W] ere we to decide this issue on a clean slate, we would not so hold.”). Moreover, the United States Court of Appeals for the First Circuit, in dicta cited Mann with approval in Eastern Savings Bank v. LaFata (In re La Fata), 483 F. 3d 13(1st Cir. 2007), a case in which the issue was “whether the bankruptcy Code’s protection of mortgage lenders against modification of claims secured by a principal residence applies when the residence in fact lies mostly on a lot abutting the mortgaged property. “Id. At 15. The case arose out of a “bizarre set of facts,” namely that the Debtor, and his current spouse “mistakenly built a house on the property line between two lots owned by the Debtor’s ex wife, a fact which was not discovered until after a mortgage on the lot believed to include the house had already been granted.”

PROCEDURE

The prevailing practice in Massachusetts is to require the Debtor to file a motion pursuant to 11 U.S.C. § 506 to determine the value of the real estate. After determination by the court as to the present value of the real estate, with the subsequent determination that the junior mortgage is, in fact, wholly unsecured, the Debtor may then treat the junior mortgage as an unsecured creditor in the Chapter 13 Plan. If, after the 506 value determination made by the court, it is concluded that the junior mortgage is partially unsecured but not wholly unsecured, the provisions of 11 U.S.C. § 1325 (a)

(5) (B) (iii) (I) shall apply requiring the Debtor to pay the entire secured portion of the claim in equal monthly installments over the life of the plan, assuming that the collateral is of a nature that is modifiable under § 1322 (b) (2), i.e., multi-unit or cross collateralized, etc. This section does not permit the use of balloon payments at the conclusion of the plan, however, a single balloon payment may possibly be viewed as a single equal payment.

INTEREST RATE MODIFICATION

Again, the modification of a secured claim's interest rate can not be achieved in a case where the claim is secured only by a security interests in the Debtor's principal residence. However, should a secured claim be determined to be modifiable pursuant to 11 U.S.C. § 1322(b) (2), then certain guidelines will allow the modification of the interest rate. Where the interest rate is modifiable pursuant to 11 U.S.C § 1322(b) (2) than such modification must be "reasonable and fair". See, In re Carman, Case No. 07-44271-JBR (Bankr. Mass. 7/25/2008)

Generally, an interest rate modification should be done through the use of a formula. Such formula should take into account, the risk factor added to the prime rate. the burden of showing the appropriate risk factor falls upon a creditor. See, Till v. SCS Credit Corp., 541 U.S. 465 (2004).

LOOKING INTO THE FUTURE

THE DEATH OF DEWSNUP

Presently, the United States finds itself in the deepest recession since World War II. Of the leading contributors to this recession, none exceeds the dilemma caused by the subprime mortgage disaster. As the mortgage defaults rose steadily through late 2006

and 2007, the mortgage meltdown became a self fulfilling formula. The mortgage defaults that occurred led to even more mortgage foreclosures which in turn led to a steep diminution in the value of real estate throughout the country. The declining values of real estate caused even more people to abandon real estate that was “underwater”. As Congress wrestles with different ideas and remedies and a new administration readies itself for the presidential office in January of 2009, some experts indicate that a change in the Bankruptcy Code may be appropriate. Specifically, Congress would give the authority to bankruptcy judges to conduct valuation hearings in an effort to determine the true secured status of a homestead mortgage on a single family residence. Up until now, the decision in In re Dewsnup v. Timm, 502 U.S. 410, (1992) has prevented any tinkering with the first mortgage market as it pertains to a single family residence. The theory, as cited in Mann, “the creditor’s rights, enforceable under state law and bargained for by the mortgagor and the mortgagee, were those which Congress chose to protect.” It is the sanctity of the first mortgage market that makes such a proposition so difficult. Generally, it is felt that in order for americans to finance the purchase of homes, there must be a constancy and dependability for those institutions that invest in these mortgage securities. To allow bankruptcy courts to modify the “value” of these mortgages is a most complex and difficult problem, However, given the depth and difficulties of the present financial crisis in the United States a new administration may just craft just such a solution.