Chapter 13 Debtors Need Not Pay Late-Filed Mortgage Arrearage Claims

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Nearly every NACBA attorney has had prospective clients walk in the office seeking bankruptcy help to save their home from foreclosure. In the "good old days" before the Great Recession and before the current loan modification craze, debtors would come to the office with relatively small mortgage arrearage claims compared to today. The arrearages in my office were small (between $15,000-$30,000) because mortgage lenders typically started and completed the foreclosure process in judicial states over a few months and there was insufficient time for the arrearage to increase dramatically ($80,000$120,000). Bankruptcy was a first resort for many homeowners because of the automatic stay protections and the ability to cure the mortgage arrearage over a 60-month period.

Bankruptcy now appears to be the last resort for many homeowners struggling with foreclosure. Worse, a mortgage arrearage balance can grow massively because the delay in the foreclosure process in judicial states has stretched from months to years. The delay emanates from due process challenges, standing and notice issues, court-mandated mediation requirements, loan modification efforts, and the advent of the foreclosure defense bar whose singular goal appears to be delaying the foreclosure sale.

a. Stripping Secured Mortgages

Consequently, NACBA attorneys had to be creative and develop new strategies to help homeowners save their underwater homes and prevent foreclosure despite huge mortgage arrearages. Attorneys started targeting wholly-unsecured second and third mortgages when the fair market value of the residential real estate securing these mortgages was insufficient to cover the senior mortgage obligations. Eight circuit courts have held that a debtor may strip-off a wholly-unsecured junior lien secured by a chapter 13 debtor's primary residence.[1]

Plus, strip-downs became a popular tool to reduce a mortgage obligation from the contractual amount owed to an amount equal to the value of the real estate securing the loan. Strip-downs of mortgages secured by non-residential real property were easy.[2] Strip-downs of mortgages not secured "only" by residential property proved successful.[3] Also, victories were had stripping-down mortgages secured by residential property in cases "in which the last payment on the original payment schedule for a claim …is due before the date on which the final payment under the plan was due."[4]

b. Objecting to Mortgage Arrearage Claims

Sometimes a chapter 13 homeowner facing foreclosure cannot afford to cure the mortgage arrearage on a senior mortgage lien, even after a junior mortgage strip-off. Until recently, these homeowners had no other chapter 13 option other than to propose a plan that (a) surrenders the property to the senior lienholder pursuant to §1325(a)(5)(C);[5] or (b) restructures the debt with the acceptance of the senior lienholder pursuant to §1325(a)(5)(A).[6] Sadly, NACBA members know how hard it is to deal with recalcitrant mortgage lenders.[7]

Now the U.S. Court of Appeals for the Seventh Circuit has given homeowners a third option: striking

a senior mortgage lender's late-filed proof of claim, and confirming a plan without any mortgage arrearage cure while preserving the homeowner's automatic stay protection through the remaining life of the plan. In a ruling of first impression at the circuit court level, the Seventh Circuit in In re Pajian[8] held that Rule 3002(c)'s[9] 90-day proof of claim filing deadline applies to secured creditors. As prevailing counsel in Pajian, I immediately recognized the strategic advantage of this ruling to NACBA attorneys striving to save homes from foreclosure despite debtors' insufficient income to cure the mortgage arrearages. A review of the case is instructive.

The Pajian debtor filed bankruptcy on the eve of a foreclosure sheriff sale on one property and after the sheriff sale of a second property. This case was debtor's second bankruptcy case in less than a year so a motion to extend the automatic stay was required by §362(c)(3)(B).[10] The mortgage lender who held notes on both properties objected to the stay extension. A trial was held and the stay was extended. Meanwhile, the claims filing deadline clock was ticking.

Debtor proposed a chapter 13 plan that bifurcated the obligations owed to the mortgage lender. The plan proposed fully paying what debtor thought was the correct mortgage arrearage on the not yet foreclosed property plus the monthly post-petition mortgage payment required by the mortgage note. The plan also proposed paying a 10% dividend for the unsecured mortgage deficiency on the already foreclosed property.

The mortgage lender objected to the plan after the proof of claim deadline had passed, asserting that the true mortgage arrearage was substantially greater than the mortgage arrearage provided in the chapter 13 plan. Debtor could not afford to cure the full mortgage arrearage asserted by the lender over the 60-month plan term.[11] So debtor responded by filing a modified plan[12] that reduced to zero ($0.00) the amount paid to the mortgage lender regarding the unsecured mortgage deficiency. Plus, the modified plan reduced to zero ($0.00) the amount of the mortgage arrearage cure, retaining only the monthly post-petition mortgage payment required by the mortgage note.

The mortgage lender responded by filing a single proof of claim after the Rule 3002(c) filing deadline, combining both its secured and unsecured claims. Debtor objected to the late-filed proof of claim asserting that Rule 3002(c)'s deadline applies to both secured and unsecured claims. The bankruptcy court sustained the objection as to the unsecured mortgage deficiency, but overruled the objection as to the secured claim for the mortgage arrearage holding that Rule 3002(c)'s filing deadline does not apply to secured claims. The bankruptcy court then found that the secured creditor's filing deadline was the date a plan was ultimately confirmed. Debtor appealed directly to the Seventh Circuit.

c. Seventh Circuit Holds Rule 3002(c) Applies to Both Secured and Unsecured Claims

The Seventh Circuit reversed the bankruptcy court and held that a secured creditor must file its proof of claim by the 90-day deadline contained in Rule 3002(c). The Pajian court began its analysis by noting that a creditor must file a proof of claim in order to participate in chapter 13 plan distributions. But while all creditors must file a proof of claim in order to receive distributions, a secured creditor who fails to do so can still enforce its lien through a foreclosure action, even after the debtor receives a discharge.[13]

The Pajian court recognized that debtors may object and courts must disallow any claim that is not timely filed.[14] But when is the deadline after which a secured creditor's claim is "late?" The Seventh Circuit stated the issue in Pajian as whether Rule 3002(c)'s deadline applies to all creditors or merely unsecured ones.

Rule 3002(a)'s[15] filing requirement applies only to unsecured creditors and does not mention secured creditors. Plus, the court noted that Rule 3002 never expressly refers to "secured creditors" anywhere. But the court segregated Rule 3002(a) as only addressing the issue of "who" must file; whereas

Rule 3002(c) addressed the issue of "when" creditors must file.

On the "when" issue, the Pajian court focused on Rule 3002(c)'s use of the phrase "proof of claim" and stressed that the drafters did not distinguish between claims of secured and unsecured creditors. "Claim" is a defined term[16] and includes a right to payment, whether or not such right is secured or unsecured. The Seventh Circuit found that the use of both terms in Rule 3002 suggests that the drafters knew how to distinguish between all claims and unsecured claims. The court believed that the drafter's decision not to limit Rule 3002(c)'s deadline to only unsecured creditors implies that the deadline applies to both secured and unsecured claims alike.

d. Strategies for NACBA Attorneys

The Seventh Circuit's Pajian ruling provides NACBA attorneys with another strategy to protect homes from foreclosure when mortgage lender's late-file or fail to file a proof of claim. First, NACBA attorneys could use the Pajian ruling as leverage against mortgage lenders which late-file or fail to file proofs of claim with the goal of pressing these lenders to modify the defaulted mortgage notes. Debtors could offer to increase the monthly post-petition mortgage payment provided in the plan if the lender agrees to include the mortgage arrearage into a recapitalized mortgage note. Alternatively, debtors could seek an extended maturity date, relaxed loan covenants, a reduced interest rate, or an interest rate change from variable to fixed.

Second, debtors who have the ability to cure the mortgage arrearage may nevertheless desire not to cure the arrearage and utilize the available funds to pay non-dischargeable debts. Consider for example a debtor with both a large mortgage arrearage and a large tax debt relating to unfiled taxes or fraudulent tax returns. The tax debts would be non-dischargeable, non-priority, unsecured debt pursuant to §523(a)(1) and (a)(2).[17] What is a debtor to do if the debtor only has enough disposable income to pay either (a) 100% of the mortgage arrearage and 10% of the non-dischargeable tax debt; or (b) no mortgage arrearage and 100% of the non-dischargeable tax debt? The debtor may decide to save the home and worry later about the 90% of the non-dischargeable tax debt that survives the bankruptcy. Alternatively, the debtor may decide to solve the mortgage arrearage issue outside of bankruptcy (e.g. loan modification) and apply all available money to the non-dischargeable tax debt.

Third, debtors who successfully complete their chapter 13 plans without paying the mortgage arrearage may be able to file a chapter 13 petition (a "chapter 26") after receiving the discharge if their financial circumstances have improved. The only debts included in a subsequent case's chapter 13 plan would be debts that were not discharged in the prior case plus the mortgage arrearage.

Fourth, plans can be confirmed that do not pay mortgage arrearage and only provide the senior lender with post-petition mortgage payments. This strategy affords debtors an additional 60 months to get their financial "house in order." While enjoying the automatic stay protections, debtors could restructure their financial lives to better manage debt obligations after the completion of the plan, including: (a) sell the real estate; (b) refinance the mortgage note; (c) allow the real estate to appreciate in value; (d) if commercial property, increase rental income by increasing rental rates and leasing any currently unleased commercial space; or (e) if residential property, increase net income by obtaining a salary increase, change jobs, rent part of the home, or improve the profitability of an existing business.

Some NACBA attorneys may object to this strategy because a debtor's "day of reckoning" would merely be postponed since the mortgage arrearage debt would not be cured during the chapter 13 plan term, the lien would not be avoided, and the mortgage note would not be discharged[18] upon plan completion. But that objection is based upon the false premise that chapter 13 debtors seek bankruptcy protection with the singular goal of fully paying all creditors and exiting bankruptcy debt-free.

Chapter 13 is about survival and managing otherwise unsustainable debt obligations, some dischargeable and some non-dischargeable. Many "successful" chapter 13 cases conclude with certain debts surviving the bankruptcy discharge, including mortgage debts,[19] student loan debts,[20] domestic support obligations,[21] certain tax debts,[22] debts for money obtained through false representations,[23] debts for fraud while acting in a fiduciary capacity or embezzlement,[24] debts relating to death or personal injury cause by operation of a motor vehicle while intoxicated,[25] debts for restitution or criminal fine,[26] and debts for damages awarded as a result of willful or malicious injury.[27]

e. Unsecured and Governmental Claims

The 7th Circuit's Pajian decision resolved an issue of first impression as to secured creditors, but did not change the filing deadline as to unsecured claims. Rule 3002(c) still provides for a 90-day filing deadline for non-governmental unsecured creditors beginning with the first date set for the meeting of creditors. Debtors could avoid paying the unsecured claims by filing objections to any time-barred unsecured claims filed after the deadline.

Government creditors holding unsecured claims are not bound by Rule 3002(c)'s general 90-day filing deadline. Instead, governmental claims unrelated to tax returns are bound by an expanded deadline set forth in Rule 3002(c)(1),[28] which creates an exception to the rule and extends the filing deadline for proofs of claim to 180 days after the date of the order for relief. Government claims relating to tax returns filed under §1308 [29] are timely filed if filed no later than 180 days after the date of the order for relief or 60 days after the date of the filing of the tax return.

The bankruptcy court is granted discretion to enlarge the time for a government unit to file a proof of claim only upon motion of the governmental unit made before expiration of the period for filing a timely proof of claim. Rule 9006(b)(3)[30] prohibits bankruptcy courts from enlarging the 90-day

rule beyond the Rule 3002(c) parameters.

f. Conclusion The U.S. Court of Appeals for the Seventh Circuit provided NACBA members with another strategy to help homeowners prevent foreclosure. NACBA attorneys should consider the Pajian ruling in any case where debtor does not have the ability to cure the prepetition mortgage arrearage or strategically decides not to pay the arrearage---either because a debtor does not have sufficient net income to cure the arrearage, or debtor would rather pay non-dischargeable debt instead.

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(Endnotes)

1 In re Schmidt, 765 F.3d 877 (8th Cir. 2014); In re Davis, 716 F.3d 331, 334-39 (4th Cir. 2013); In re Zimmer, 313 F.3d 1220, 1222-27 (9th Cir. 2002); In re Lane, 280 F.3d 663, 665-69 (6th Cir. 2002); In re Pond, 252 F.3d 122, 124-27 (2nd Cir. 2001); In re Tanner, 217 F.3d 1357, 1358-60 (11th Cir. 2000); In re Bartee, 212 F.3d 277, 284-95 (5th Cir. 2000); In re McDonald, 205 F.3d 606,609-15 (3rd Cir. 2000).

2 11 U.S.C. §§1322(b) and 1325(a)(5).

3 Id.

4 11 U.S.C. §§1322(c)(2).

5 11 U.S.C. §1325(a)(5)(C).

6 11 U.S.C. §1325(a)(5)(A).

7 "Foaming the Runway" for Homeowners: U.S. Bankruptcy Courts "Preserving Homeownership" in the Wake of the Home Affordable Modification Program, 23 American Bankruptcy Institute Law Review 421 (2015) (Coco, Linda)

8 In Re Pajian, No. 14-2052 (7th Cir. May 11, 2015).

9 Fed. R. Bankr. P. 3002(c).

10 11 U.S.C. §362(c)(3)(B).

11 See 11 U.S.C. §1322(b)(5), which provides for the curing of any default within a reasonable time and maintenance of payments while the case is pending.

12 See 11 U.S.C. §1323(a), which allows for the filing of a modified plan before confirmation.

13 See In re Penrod, 50 F.3d 459, 461-62 (7th Cir. 1995).

14 11 U.S.C. §502(a), (b)(9).

15 Fed. R. Bankr. P. 3002(a).

16 11 U.S.C. §101(5)(A).

17 11 U.S.C. §523(a)(1), (a)(2).

18 See 11 U.S.C. §1328(a).

19 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §1322(b)(5).

20 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(8).

21 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(5).

22 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(1).

23 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(2).

24 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(4).

25 See 11 U.S.C. §1328(a)(2) incorporating 11 U.S.C. §523(a)(9).

26 See 11 U.S.C. §1328(a)(3).

27 See 11 U.S.C. §1328(a)(4).

28 Fed. R. Bankr. P. 3002(c)(1).

29 11 U.S.C. §1308.

30 Fed. R. Bankr. P. 9006(b)(3).