# Consumer Debtor Class Actions: One More Windmill, or the Ultimate Remedy for the Subprime Mess?

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# Debtor Class Actions in Bankruptcy

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# Foreclosure Charges by Lender Investigated

The New York Times, September 28, 2007

"The federal agency monitoring the bankruptcy courts has subpoenaed Countrywide Financial, the nation's largest mortgage lender and loan servicer, to determine whether the company's conduct in two foreclosures in Southern Florida represented abuses of the bankruptcy system."

# U.S. Expands Scrutiny of Home Lenders/Services

## WSJ, December 3, 2007

"Attorneys from the U.S. Trustee Program, a division of the Justice Department, have taken aim at mortgage lenders, servicers and their lawyers in at least six states, including Georgia, Massachusetts and Pennsylvania… The agency is probing representations made to courts about what homeowners owe and the handling of their payments during bankruptcy, both areas in which consumer advocates say there are pervasive problems."

# Lender Abuses Alleged by Debtors

- Lenders overinflate amounts alleged due in proofs of claim.
- Lenders pursue discharged debts not properly reaffirmed.
- Lenders fail to account for the debtor's payments and the Chapter 13 Trustee's payments during the life of the plan.
- Lenders add fees and charges not approved by the Bankruptcy Court.
- Lenders do these things continually in numerous cases across the country.

# Debtors Allege Such Actions Lead To:

- Lenders filing proofs of claim for inflated amounts.
- Lenders filing motions for relief from stay alleging the debtor is behind, when in fact, the debtor is not behind, or not behind in amount claimed.
- After discharge, lenders quoting inflated payoff amounts and collecting amounts not owed.
- After discharge, lenders asserting that the debtor is in default, begin foreclosure proceedings, and actually foreclose.

# In re Fagan
# 376 B.R. 81 (Bankr. S.D.N.Y. 2007)

"Motions to lift the stay may be routine and inconsequential to secured creditors and their counsel. But to a debtor and his or her family, such a motion and the consequent loss of the family home may be devastating. Most creditors and counsel are conscientious. But some are callous by design or inadvertence, as exemplified by this motion and two others presented to the Court the same week."

“The danger here is that a debtor who does not have an attorney or the resources of intellect or spirit to defend against a baseless motion may lose his/her home despite being current on post-petition mortgage and plan payments.”

In re Jones, 2007 Bankr. LEXIS 2984 (Bankr. E.D. La. August 29, 2007)

"Wells Fargo avers that it was Debtor's burden to discover that it had clandestinely assessed and paid itself for undisclosed fees and charges otherwise not due. Incredibly, Wells Fargo also argues that it was Debtor's burden to verify that its accounting was correct, even though Wells Fargo failed to disclose the details of that accounting until it was sued."

“The final assault on the Bankruptcy Code is Wells Fargo’s position that not only can it secretly assess a debtor’s account postpetition, but it can collect payment on these charges without seeking Court permission…

Depending on how much and how often the lender siphoned off funds, payable under a confirmed plan for other purposes, a debtor might or might not satisfy the obligations contemplated by his or her plan.

To allow such a practice is to eviscerate the provisions of the automatic stay and this court’s power to protect the Debtor and property of the estate.”

# Types of Relief Sought

- Restitution of overpayment
- Sanctions for creditor's violation of Code sections
- Actual damages (including emotional distress)
- Statutory damages
- Punitive damages
- Attorneys' fees
- Injunctive Relief
- Proof of Claim Objections

- Violation of Other Federal Statutes
  - Fair Debt Collection Practices Act
  - RESPA
  - HOEPA
  - TILA
  - Fair Credit Reporting Act
- Violation of State Consumer Protection Laws

# Lender/Servicer Responses

- Bankruptcy Requirements Vary -- Often By District and Even By Judge
  - See Professor Zywicki Affidavit (in materials)
- Many Questions Unresolved By Code Or By Caselaw, Which Is Sparse
- Servicing Loans Across Country Is Challenging
- Defaulted Loans Are Particularly Difficult To Service
  - Uneven Payments - including from trustees
  - Third Parties' Invoices

# Lender/Servicer Defenses to Debtor Class Actions

- No Jurisdiction Over Debtor Class Actions
- Comity/Interference Principles
- Class Certification Standards Are Not Met
- Merits Of Claim

# Jurisdiction

- Not within scope of 1334(b)
- Implicates property of the estate, and so can only be addressed by home court under 1334(e)
- Not a “proceeding” in a “referred” case
- Distant court has no jurisdiction to apply home court’s orders
- Suits amount to collateral attack

See Defense Brief in In re Jones, Adv. No. 05-1214 (Bankr. D. Nev.) (in materials)

# Comity/Interference

- Nationwide class interferes with other courts' cases
- Relief would undermine local procedures, rules, customs, settled expectations – See B.R. 9029
- Would interrupt ongoing cases, lead to inconsistent result affecting estate
- Res judicata and collateral attack concerns
  - Even where issue could have been litigated
- "Litigation about litigation"

See In re Morrow, Adv. No. 99-70087, "Order Defining Class To Be Certified" (Bankr. N.D. Ala.); and, Defense brief in In re Jordan, Adv. No. 03-1132 (Bankr. S.D. Ala.) (in materials)

# Class Certification

- Common issues do not predominate
  - Need to examine what happened in each case
    - For example, for claim concerning fees under Section 506(b)
      - Contract terms vary
      - Work done varies
      - Reasonableness of fees varies
    - Plan may not request payment of fees – In re Tomasevic, 275 B.R. 86 (M.D. Fla. 2001); 11 U.S.C. § 1328(a)(court acts only on debts "provided" in plan)
  - Debtor consent
    - Smith v. PNC Mortgage Corp., Adv. No. 99-1138, slip op. (Bankr. S.D. Ala.)

- There is no nationwide law of bankruptcy
  - Henry v. Associates Home Equity Serv., Inc., 272 B.R. 266 (C.D. Cal. 2002)
- Comity/interference/local legal culture
  - In re Powe, 278 B.R. 539 (Bankr. S.D. Ala. 2002)
  - Morrow v. Countrywide Home Loans, Adv. No. 99-70087, slip op. (Bankr. N.D. Ala.)(in materials)
- Not a superior or manageable undertaking
  - The North Carolina experience – no “holy war”
  - The Alabama experience – relief difficult to manage without settlement

# Debtors' Responses to Class Defenses

- The District Court has the jurisdiction over bankruptcy matters – there is no "bankruptcy court jurisdiction"
    - Such jurisdiction is not limited to protecting the rem, but also debtor and his rights
    - Such jurisdiction is not exclusive

- District courts certify nationwide classes regarding federal statutes despite fact that other courts rule differently on those statutes

- Conduct under attack is violation of a statute – not a particular court's order
    - In re Bessette, 230 F. 3d 439 (1st Cir. 2000)

- Common issues and facts do predominate – lender commits same violation in every case

- Class actions are only way to really redress the wrong done to debtors, as amounts are small in each case but costs to litigate enormous

- Bankruptcy Rule 7023 exists

- Class makes it more manageable to address lenders' actions, not less

    - In re Manley, 273 B.R. 229, 249 (N.D. Ala. 2001)

- Court can define class based on consideration of other similar proceedings to alleviate concerns about comity/interference

    - In re Noletto, 244 B.R. 845 (Bankr. S.D. Ala. 2000)

- Huge nationwide class actions already have been certified by bankruptcy courts on these issues

# Bankruptcy Court "Jurisdiction" Over Class Actions

## Bankruptcy Court has Jurisdiction Over Nationwide Class

- In re Noletto, 244 B.R. 845 (Bankr. S.D. Ala. 2000);
- Fleet v. U.S. Consumer Council Inc.. (In re Fleet), 53 B.R. 833 (Bankr. E.D. Pa. 1985);
- Powe v. Chrysler Fin. Corp. LLC (In re Powe), 278 B.R. 539, 280 B.R. 728 (Bankr. S.D. Ala. 2002), appeal dismissed sub nom. Chrysler Fin. Corp. v. Powe, 312 F.3d 1241 (11th Cir. 2002);
- Sheffield v. Homeside Lending, Inc. (In re Sheffield), 281 B.R. 24 (Bankr. S.D. Ala. 2000);
- In re Harris, 280 B.R. 876 (Bankr. S.D. Ala. 2001), app. dism, Chrysler v. Financial Corp. v. Powe, 312 F.3d 1241 (11th Cir. 2002);
- In re Slick, 2002 Bankr. LEXIS 772 (Bankr. S.D. Ala. May 10, 2002);
- Bank United v. Manley, 273 B.R. 229 (N.D. Ala. 2001);
- In re Sims, 278 B.R. 457 (Bankr. E.D. Tenn. 2002);
- Harris v. Washington Mutual Home Loans (In re Harris ), 297 B.R. 61 (Bankr. N.D. Miss. 2003), aff'd Harris v. Washington Mut. Home Loans, Inc.. (In re Harris), 312 B.R. 591 (N.D. Miss 2004);
- Patrick v. Dell 344 B.R. 56 (Bankr. E.D. Pa. 2005);
- Aiello v. Providian Fin. Corp. (In re Aiello), 231 B.R. 693 (Bankr. N.D. Ill. 1999).

## Bankruptcy Court does not have Jurisdiction Over Nationwide Class

- Fisher v. Federal Nat'l Mortgage Ass'n (In re Fisher), 151 B.R. 895, 897 (Bankr. N. D. Ill. 1993);
- Nelson v. Providian Nat'l. Bank, 234 B.R. 528, 538 (Bankr. M.D. Fla. 1999);
- Knox v. Sunstar Acceptance Corp., 237 B.R. 687, 693 (Bankr. N.D. Ill. 1999);
- Lenior v. GE Capital Corp., (In re Lenior), 231 B.R. 662, 667-668 (Bankr. N.D. Ill. 1999);
- Simmons v. Ford Motor Credit Co. (In re Simmons), 237 B.R. 672, 676 (Bankr. N.D. Ill. 1999);
- Cline v. First Nationwide Mtg. Corp., 282 B.R. 686, 689 (W.D. Wash. 2002);
- Beck v. Gold Key Leasing, Inc. (In re Beck), 283 B.R. 163, 175 n. 18 (Bankr. E.D. Pa. 2002);
- Singleton v. Wells Fargo Bank, N.A. (In re Singleton), 284 B.R. 322, 325 (D.R.I. 2002);
- Henry v. Associates Home Equity Services Inc.., 272 Bankr. 266 (C.D. Cal. 2002) ;
- Barrett v. Avco, 279 B.R. 442 (D.R.I. 2002) ;
- Montano v. First Light Fed. Credit Union (In re Montano), 2007 Bankr. LEXIS 3125 (Bankr. D.N.M. Sept. 10, 2007).

# Courts That Have Certified Class Actions on Bankruptcy Issues

- Conley v. Sears, Roebuck & Co., No. 97-11149 (D. Mass.), Conley v. Sears, Roebuck & Co., 222 B.R. 181, 185--86 (D. Mass. 1998) and Brioso v. Sears, Roebuck & Co., Adv. Proc. No. 97-1222 (Bankr. D. Mass.)(settlement returned 150% of debt collected pursuant to invalid reaffirmations to approximately 190,000 debtors);

- In re Coggin, 155 B.R. 934 (Bankr. E.D. N. C. 1993) (Court certified nationwide class concerning Sears reaffirmation agreements);

- In re General Electric Capital Corp. Consumer Bankruptcy Debtor Class Action Litigation, MDL No. 1192 (N.D. Ill.) ($100 million settlement; 100,000 class members [approximate]);

- Mazola v. May Dept. Stores Co., No. 97-10872 (D. Mass.) ($20 million settlement, 40,000 class members [approximate]);

- Hurst v. Federated Dept. Stores Co., No. 11479 (D. Mass.) ($5 million settlement, 12,000 class members [approximate]);

- Lafromboise v. Greenwood Trust Co., No. 97-30091 (D. Mass.) ($4 million settlement, 23,000 class members [approximate]).

- Mobile Proof of Claim Fees Cases:
  - In re Noletto, 280 B.R. 868 (Bankr. S.D. Ala. 2001);
  - In re Powe, 278 B.R. 539 and 280 B.R. 728 (Bankr. S.D. Ala. 2002);
  - In re Sheffield, 281 B.R. 24 (Bankr. S.D. Ala. 2002);
  - In re Harris, 280 B.R. 876 (Bankr. S.D. Ala. 2001), app. dism, Chrysler v. Financial Corp. v. Powe, 312 F.3d 1241;
  - In re Slick, Case No. 98-14378-MAM, Adv. No. 99-1136, 2002 Bankr. LEXIS 772 (Bankr. S.D. Ala. May 10, 2002)( Wells Fargo sanctioned $2 million)
- Lau v. Arrow Financial Services, LLC, 245 F.R. 620 (N.D. Ill. 2007)(district court certifies FDCPA class against creditor alleged to be collecting discharged debts);
- Tate v. Nationsbanc Mortgage Corp. (In re Tate), 253 B.R. 653, 663 (Bankr. W.D. N.C. 2000)(court certifies district-wide case on unapproved fees in proofs of claim);
- Harris v. Washington Mutual Home Loans (In re Harris), 297 B.R. 61 (Bankr. N.D. Miss. 2003), aff'd Harris v. Washington Mut. Home Loans, Inc. (In re Harris), 312 B.R. 591 (N.D. Miss 2004)(after district court affirmed lower court's ruling that it had jurisdiction over nationwide class, at least two defendants settled on class-wide basis);
- In re Sims, 278 B.R. 457 (Bankr. E.D. Tenn. 2002)(class settlement);
- In re Morrow, C.A. No. 99-70087, slip opinion (Bankr. N.D. Ala. 2003) (in materials)(court certifies district-wide class).

# Merits Defenses to the Causes of Action

- Vary depending on claim
- Some courts have agreed with some of the lender's defenses
- One example, proof of claim fees
  - They are legal – E.g., Majchrowski v. Norwest Mortgage, Inc., 6 F. Supp.2d 946, 966 (N.D. Ill. 1998); In re Atwood, 293 B.R. 227 (9th Cir. BAP 2003); In re Powe, 278 B.R. at 557.
  - Minimal or no additional disclosure requirements
  - Cause of action inconsistent with Section 1322 – In re Bateman, 331 F.3d 821 (11th Cir. 2004)
  - No cause of action under 506(b) or 105; no violation of 362
    - In re Henthorn, 299 B.R. 351, 356 (E.D. Pa. 2003)(506(b) and 105)
    - Pertuso v. Ford Motor Credit, 233 F.3d 417 (6th Cir. 2000)(105); Holloway v. Household Auto. Fin. Corp., 227 B.R. 501, 506 (N.D. Ill. 1998)(105)
    - Mann v. Chase Manhattan Mortgage Corp., 316 F.3d 1 (1st Cir. 2003)(362)

# Additional Merits Defenses

- Factual
  - Often, what is alleged did not occur
  - If it did, it was an exception –
    - Bankruptcy often a “manual process”
    - Courts actually asking for individualized consideration – humans make mistakes
  - Third parties (especially local attorneys) err or do not follow instructions
- Courts or debtors request inconsistent things
  - Monthly statements –Wetzel v. HomEq, C.A. No. 07-42 (S.D. Ohio)
- Courts or debtors request things not required
- “Enact a local rule” – In re Smith, Adv. No. 00-3148 (Bankr. W.D.N.C. 2000)(in materials)

# Other Courts Provide Relief to the Debtors

- Failure to Disclose Fees Under 506(a) and 2016(b) is per se unreasonable
    - In re Sanchez, 372 B.R. 289 (Bankr. S.D. Tex. 2007)
    - In re Tate, 253 B.R. 653 (Bankr. W.D.N.C. 2000)
- Code provisions create substantive rights for debtors
    - In re NGC Settlement Trust, 118 F.3d 1056, 1063 (5th Cir. 1997) (discharge injunction is substantive right)
- Court can redress lender abuses of the Bankruptcy Code, including awarding actual damages, punitive damages, disgorgement, attorneys' fees and issuing sanctions and injunctions
- Use 105(a), contempt powers
    - In re Bessette, 230 F.3d 439 (1st Cir. 2000)
    - In re Terrebonne Fuel and Lube, Inc., 108 F.3d 609, 612-13 (5th Cir. 1997(court can use 105(a) for contempt of discharge injunction)

# 11 U.S.C. Section 105(a)

"The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process."

» In re Marrama, 127 S.Ct. 1105 (2007)

# Courts Providing Relief to Debtors

- In re Nosek, 363 B.R. 643 (Bankr. D. Mass. 2007)
  - Court awards $250,000 in emotional distress damages and $500,000 in punitive damages for Ameriquest's violation of 1322(b) and failure to account for debtor's chapter 13 payments.
- In re Fagan, 376 B.R. 81 (Bankr. S.D.N.Y. 2007)
- In re Wines, 239 B.R. 703, 709 (Bankr. D.N.J. 1999)
- In re Jones, 2007 Bankr. LEXIS 2984 (Bankr. E.D. La. August 29, 2007)
  - Court states that award of $67,202.45 in Debtors' costs and legal fees was really de minimus and insufficient to act as a deterrent to future misconduct, noting its view that $2,000,000 sanction imposed against Wells Fargo's predecessor in 2002 was apparently not enough to deter Wells Fargo's "sanctionable actions" which had continued. Court ordered Wells Fargo to change its accounting procedures.
- In re McCormick, 203 B.R. 521 (Bankr. D.N.H 1996)
  - Court rejects "computer did it" defense – imposed $10,000 in punitive damages on Chase noting that Chase employees were not "precluded from getting a quill pen and ledger book to keep track of the effects of a chapter 13 plan in progress if indeed it was beyond the powers of mortal men and women to re-program their computer."

- Maxwell v. Fairbanks, 281 B.R. 101 (Bankr. D. Mass. 2002)
    - Court found that Fairbanks violated the FDCPA, RESPA and the Massachusetts TILA. Noted that "Fairbanks, in a shocking display of corporate irresponsibility, repeatedly fabricated the amount of the Debtor's obligation to it out of thin air." Case settled for full discharge of mortgage, $50,000 in damages and attorneys fees.
- In re Garvida, 347 B.R. 697 (9th Cir. BAP 2006)
    - Adjustment of the mortagee's claim was appropriate when servicer could not provide an accounting after Court ordered it to do so.
- In re Gorshtein, 285 B.R. 118 (Bankr. S.D.N.Y. 2002)
    - Rejected "dog ate my homework" defense. In each of three separate cases at issue, the servicer's actions had created a danger that a family would lose its home without just cause and in violation of the bankruptcy code.
- In re Sanchez, 392 B.R. 289 (Bankr. S.D. Tex. 2007)
    - Creditor holding a lien on a debtor's homestead may not assess a debtor post-petition charges without giving notice to the debtor and without seeking court approval, whether or not those charges are specifically allowed under a pre-petition contract. Court holds that it can use 105(a) to enforce 506, Rule 2016, 362, impose actual and punitive damages, hold lender and firm in contempt and issue injunction.
- In re Ryerson, 2006 Bankr. LEXIS 3721, at #7-8 (Bankr. M.D. Fla. Nov. 20, 2006)
    - Court denied Chase's summary judgment motion that alleged debtor had no cause of action under Sections 1322(b)(5), 1322(a)(1), 1326, 1327(a) or 105.
- In re Padilla, 2007 Bankr. LEXIS 2655 (Bankr. S.D. Tex. August 3, 2007)
    - Section 506 applies pre-confirmation, and Rule 2016(a) applies post-confirmation. The debtors "are not defenseless against alleged abusive charges by their mortgage lenders."

# Lenders' Law Firms Held Accountable

- Judge Morris Stern fined a new Jersey law firm for filing 250 court pleadings in which the signature page had been "pre-signed" before review by the servicer.
    - In re Rivera, 342 B.R. 435 (Bankr. D.N.J. 2006)
- Judge Steen recounts numerous instances of Texas law firm being sanctioned by bankruptcy courts for improper filings – fining firm $75,000.
    - In re Allen, No. 06-60121 (Bankr. S.D. Tex. June 18, 2007)(discussing other cases where same law firm had been fined or sanctioned)(in materials)
- Judge Bohm issued a show cause order as to why Countrywide and its counsel should not be sanctioned for filing a motion for relief from stay that was allegedly inaccurate. Court later ruled that the U.S. Trustee had standing to appear and be heard on matters raised in show cause orders and had the right to conduct discovery under Rule 2004.
    - In re Parsley, No. 05-90374 (Bankr. S.D. Tex., Feb. 12, July 17, 2007)(docket sheet)
- Judge Doug Dodd awarded sanctions against creditor's counsel for a baseless stay relief motion of $5,000 (emotional distress damages) and reasonable attorney's fees.
    - In re Osborne, 375 B.R. 216 (Bankr. M.D. La. 2007),

# Articles, Treatises

- Corrine Ball & Micelle J. Meises, Current Trends in Consumer Class Actions in the Bankruptcy Arena, 56 Bus. Law 1245 (May 2001)

- Elizabeth Warren and Jay Westbrook, Class Actions for Post-Petition Wrongs: National Relief Against National Creditors, 22 –2 ABIJ (March 2003)

- Robert P. Wasson, Article: Remedying Violations of the Discharge Injunction Under Bankruptcy Code 524, Federal and Non-Bankruptcy Law and State-Law Comports with Congressional Intent, Federalism and Supreme Court Jurisprudence for Identifying the Existence of an Implied Right of Action, 20 Bankr. Dev. J. 77 (2003)

- 1 Collier Pamphlet Ed. Overview 1334, Mathew Bender & Co., Inc., 2006, p. 6-7

- Katherine Porter, Abstract, Misbehavior and Mistake in Bankruptcy Mortgage Claims, 2008, University of Iowa, available at http://ssrn.com/abstract=1027961

# Questions?

Disclaimer: This presentation summarizes certain cases, arguments and developments, and is for educational purposes only. It should not be attributed as the views either of the presenters or of their clients.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF TEXAS
VICTORIA DIVISION

| | | |
|---|---|---|
| IN RE: | | |
| JAMES PATRICK ALLEN | § | CASE NO: 06-60121 |
| Debtor(s) | § | |
| | § | CHAPTER 13 |

**MEMORANDUM OPINION**
**CONCERNING NATURE AND AMOUNT OF SANCTIONS**

On January 9, 2007, the Court issued a memorandum concluding that Barrett Burke Wilson Castle Daffin & Frappier, L.L.P. ("Barrett Burke") had violated rule 9011 of the Federal Rules of Bankruptcy Procedure (FRBP) in this case. The memorandum also concluded that Barrett Burke had failed to send the attorney in charge (or a fully authorized and informed attorney) to hearings.[1] The particulars are set forth in the memorandum opinion. By order issued concurrently with the memorandum, the Court set a hearing to determine the nature and amount of sanctions. For reasons set forth below, and by separate order issued this date, the Court imposes sanctions of $75,000.

## I. BACKGROUND

The prior opinion, docket number 62, sets out, in detail, the conduct that the Court finds to be sanctionable. Barrett Burke does not contest the Court's findings or conclusions:

> The Barrett Burke law firm does not contest the validity or accuracy of this Court's findings as it relates to the mistakes and the issues relating to the mistakes.
>
> Those mistakes, indeed, were egregious and are acknowledged and full responsibility is taken...
>
> Nothing excuses the actions in this case...[2]

Because those findings and conclusions have been previously set out in writing and are uncontested, the Court will not repeat them here. The prior memorandum opinion is incorporated by reference.

In that prior memorandum opinion, the Court referenced prior warnings and sanctions that had been issued to Barrett Burke. The Court set a hearing on March 22 to determine what

[1] Local Rule 11.2 of the local rules of the United States District Court for the Southern District of Texas states: "LR11.2 **Responsibility.** The attorney-in-charge is responsible in that action for the party. That individual attorney shall attend all court proceedings or send a fully informed attorney with authority to bind the client." District Court local rules are applicable in the bankruptcy court by virtue of bankruptcy local rule (BLR) 1001(b).

[2] Transcript from March 22 hearing p. 10 ln. 6-14, p. 12 ln. 15.

nature and amount of sanctions were necessary to deter future inappropriate conduct. The March 22 hearing was continued and was concluded on May 11. This memorandum opinion will address only the issues that must be addressed with respect to the amount and nature of sanctions that should be imposed.[3]

## II. *TOPALIAN V. EHRMAN*, 3 F.3D 931 (5TH CIR. 1993)

*Topalian* establishes that a court must answer four specific questions when imposing sanctions:

1. What conduct is being punished or is sought to be deterred by the sanction?
2. What expenses or costs were caused by the violation of the rule?
3. Were the costs or expenses "reasonable" as opposed to self-imposed, mitigable, or the result of delay in seeking court intervention?
4. Was the sanction the least severe sanction adequate to achieve the purpose of the rule under which it was imposed?

## III. APPLICATION OF THE *TOPALIAN* FACTORS

A. What conduct is being punished or is sought to be deterred by the sanction?

The conduct that is being punished is set out in great detail in the prior memorandum opinion, about which Barrett Burke has no quarrel.

The conduct that is sought to be deterred is the filing of pleadings with the court that are clearly wrong (even contrary to the information in Barrett Burke's own files) or that otherwise are not thoughtful, considered, and intelligible. Further, the Court seeks to discourage Barrett Burke from failing to attend hearings that have been set on its motions and from making token appearances in other hearings through local counsel who are so ill-informed that they actually misinform the Court.

B. What expenses or costs were caused by the violation of the rule?

The expenses or costs were the time and efforts of Debtor's counsel, the chapter 13 trustee, and the Court (i) reviewing and responding to pleadings that were meaningless; (ii) reviewing and responding to a pleading that purported to be a "withdrawal" of the first offensive pleading but was in fact more meaningless than the pleading it withdrew; (iii) preparing for and attending a hearing that was unnecessary; (iv) continuing a hearing based on incorrect representations to the Court; (v) having to continue the second hearing because Barrett Burke

[3] A substantial part, perhaps the majority, of Barrett Burke's presentation at the May 11 hearing was the contention that the firm's reputation and relationship with clients had been damaged by the Court's written conclusion that Barrett Burke's conduct was egregious. Even though the word "egregious" is the word chosen by counsel for Barrett Burke, counsel earnestly and forcefully asked the Court to avoid strong statements and forceful analysis in this memorandum because such language might exacerbate the perceived harm. The Court will honor that request, to the extent possible. The analysis in this memorandum is minimalist. However, counsel for Barrett Burke also made it clear that, to justify the sanctions imposed, the Court must make the findings required by the Fifth Circuit. The line between (i) sufficient explanation to explain the Court's reasoning and (ii) minimal adverse statements is a difficult line to walk.

was not prepared for trial; (vi) conducting a final hearing that was equally unnecessary, and (vii) delaying confirmation of Debtor's chapter 13 plan. The details are found in the Court's prior memorandum opinion.

Determination of the amount of these expenses and costs is not possible. There are simply no records to compute the Trustee's costs or the value of the Court's time, for example. Having spent more than 13 years presiding over chapter 13 fee applications and being generally aware of the costs and expenses of litigation, the Court estimates that the actual costs and expenses of Debtor's counsel alone substantially exceed $5,000.[4] The cost of the efforts of the chapter 13 trustee and the Court are at least twice that. Therefore a very, very conservative estimate would be $15,000.

C. Were the costs or expenses "reasonable" as opposed to self-imposed, mitigable, or the result of delay in seeking court intervention?

There is no justification for these costs. Barrett Burke concedes that there is no excuse for its conduct.

D. What is the least severe sanction adequate to achieve the purpose of the rule?

As the US Trustee points out:[5] "The Advisory Committee Notes to the 1993 Amendments to Rule 11 provide a non-exhaustive list of factors that the Court may consider in determining the appropriate type and amount of sanction. They include, *inter alia*: a) whether the improper conduct was part of a pattern of activity or an isolated event; b) whether the person has engaged in similar conduct in other litigation; c) what effect the improper conduct had on the litigation; d) whether the responsible person is trained in the law; and e) what amount of monetary sanctions, given the financial resources of the offending party, will be sufficient to deter a repetition of similar conduct."[6]

The impact of the improper conduct has been addressed above. The remaining factors will be treated below.

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[4] Barrett Burke has offered to pay the expenses of Debtor's counsel. Based on statements in open court, the Court believes that this matter has been resolved. The number is estimated solely to give an order of magnitude to the costs to one of the three parties involved.

[5] Barrett Burke has complained bitterly about the participation of the US Trustee in this matter. The US Trustee is a party in interest with the authority to be heard on any matter (11 U.S.C. § 307). The US Trustee participated in this hearing in his capacity as a party in interest at the request of the Court. His participation assured presentation of a complete factual and legal case. Courts do not function well when only one side of an issue is presented. A party is not likely to present enthusiastically or completely the authorities, argument, and evidence that do not support his or her position, and is not likely to cross-examine his or her own witnesses. The judicial system requires an adversarial presentation. The US Trustee provided an invaluable benefit to the case and to the process by his professional participation.

[6] Statement of the US Trustee, docket # 77, page 26. *See also* the authority cited the US Trustee in footnote 15 of the referenced statement.

1. Whether the improper conduct was part of a pattern of activity or an isolated event, and whether the law firm has engaged in similar conduct in other litigation—these factors are addressed together[7]

The Court has examined a number of similar incidents involving Barrett Burke over the past four years. The Court concludes that the improper conduct was part of a pattern of activity and that Barrett Burke has been warned numerous times to correct its deficiencies.

a. *In re Thompson*, Case No. 01-10399 (Bankr. N.D. Tex. 2003)

Barrett Burke filed a motion for relief from stay on behalf of CitiFinancial Mortgage Company asserting that the debtors had defaulted on four post petition payments. The response filed by the debtors asserted the motion was filed in bad faith because all payments were current, the home was insured, and no grounds existed to warrant relief.

At the hearing on the motion, no argument or evidence was offered in support of the motion. The Court allowed additional time to present evidence, but Barrett Burke presented none. The Court found that Barrett Burke had violated its duty by failing to verify the factual basis for the motion, or by failing to withdraw the motion when apprised of Debtor's position. The Court imposed sanctions of $2,500 plus $575 for attorney's fees and expenses. Barrett Burke and CitiFinancial were held jointly and severally liable for the total amount.

The Court sees similarity in that no evidence was offered at the hearing on Barrett Burke's motion, despite the court allowing additional time. Further, Barrett Burke failed to take appropriate steps to resolve the matter; Barrett Burke failed to support or to withdraw the motion after filing it.

b. *In re Davis*, Case No. 02-10389 (Bankr. N.D. Tex. 2003)

Barrett Burke filed a motion for relief from stay on behalf of Wells Fargo Home Mortgage Inc. At the hearing, the parties advised the Court that they had reached an agreement and that Barrett Burke would upload an agreed order. The order was uploaded and was entered June 27, 2003; but the order that Barrett Burke uploaded was materially different from the form of order that had been agreed by the parties. The debtor's attorney contacted Barrett Burke by letter, advising that the order submitted to the court was substantially different from the agreed order. Barrett Burke told debtor's counsel that a corrected order would be submitted. Despite that assurance, Barrett Burke took no action to correct the order until debtor's counsel filed a motion to vacate the order and for sanctions.

Barrett Burke contended that uploading the incorrect form of order was an honest mistake that was compounded by Barrett Burke's further mistake in failing to submit timely a corrected order. No explanation was given as to how the mistake was made. The Court concluded that the changes to the order were intentional; and Barrett Burke's failure to cure the problem reflected a cavalier attitude toward the situation or a failure to implement internal procedures that insure that

[7] The Court has looked to the original pleadings, orders and transcripts where available to expand upon the summaries offered by Barrett Burke.

any such mistakes are corrected. Finding bad faith, the Court allowed debtor's attorneys fees and costs of $3,500 and an additional sanction of $2,500.

The Court sees similarities in that Barrett Burke filed an incorrect form of order and failed, even after notice, to correct the error timely.

c. *In re Smith*, Case No. 04-41212 (Bankr. S.D. Tex. 2004)

Barrett Burke filed a motion for relief from stay on behalf of Suntrust Mortgage, Inc. The motion alleged that the debtors were delinquent on four payments and that debtor had no equity in the property that secured a note in the original amount of $27,700, docket # 14. On October 25, Barrett Burke filed a motion to amend, alleging a $221,900 note instead of a $27,000 note, docket #17.

On October 29, Barrett Burke filed a second motion for relief from stay on the same property, alleging the same principal amount that was in the first motion for relief from stay, $27,700, docket #19. The motion and the exhibit summary are substantively identical to the ones filed October 4. Barrett Burke withdrew the October 29 motion at hearing on November 22.

On November 24, Barrett Burke filed a motion for approval of an agreement lifting the stay on the same property. On December 18, 2004, the Court ordered Barrett Burke to appear and to explain the four motions (one amended) on the one piece of property.

At the hearing, counsel explained that the series of motions were meant to address a first and second lien on the same property. There was no explanation in the motions that would have allowed the debtor, the Court, or anyone else to understand that. No note or other documentation was attached to the motions that would have made this clear. Counsel explained that the first motion was incorrectly filed for the second lien instead of the first lien. The second motion was filed to correct the first motion. The third motion was for the second lien. This had confused Barrett Burke's case manager, a paralegal, causing the third motion to be withdrawn by accident under the belief it was a duplicate motion.

That explanation suggested that pleadings were being drafted by computer and managed by paralegals, without adequate professional oversight and review, or that Barrett Burke's pleadings were meaningless boilerplate. The Court expressed its concern over the confusing pleadings. The Court emphasized the importance of assuring that "the motion makes sense on its face and that the Court can understand what's going on in a case and it doesn't have to, sort of, try to put it all together."[8]

The Court sees similarities to the conduct in the case at bar since it demonstrates a pattern of conduct of filing pleadings that are confusing at best and meaningless at worst. The Court did not impose sanctions in this case, but suggested that Barrett Burke improve its pleadings.

[8] Case No. 04-41212, Doc. # 104, p. 6, ln. 10-12.

d. *In re Cordova*, Case No. 04-50312 (Bankr. S.D. Tex. 2005)

Barrett Burke filed a motion for relief from stay on behalf of Litton Loan Servicing, LP alleging that the debtors had defaulted on four payments. When the motion was filed, Litton was the servicing agent for the debtor's mortgage held by JP Morgan Chase Bank. Litton's motion was called for hearing on January 12, 2005. Local counsel on behalf of Barrett Burke asked for a continuance, stating that the loan servicing agent had changed and therefore Litton did not have complete and accurate data concerning the loan arrearage.[9] Concerned about how a motion could be filed without adequate records, the Court issued an order to show cause why sanctions were not appropriate, noting that the motion was essentially boilerplate and lacked thoughtful drafting. The court also noted that the motion alleged that supporting documents were attached, which was false. The Court noted that it had noted similar issues in other pleadings filed by Barrett Burke.[10]

At the hearing on February 3, Barrett Burke reported that it had originally prepared the motion on representations by Litton which counsel accepted as true, and therefore Rule 9011 sanctions against counsel were not appropriate. Counsel also reported that the loan servicing duties had been transferred not just once, but twice, and that counsel had no relationship with the new servicing agent and therefore could not appear before the Court on the motion.

This statement to the Court differed materially from the statement made by local counsel who appeared for Barrett Burke at the initial hearing. Local counsel had said that a continuance was needed because Litton did not have complete and accurate data. In fact, the problem was that Litton had abandoned the matter (because it was no longer the servicer), and Barrett Burke was trying to make arrangements with the new servicer to allow Barrett Burke to continue with the engagement for this new client. At the second hearing, Barrett Burke took the position that it could not proceed with the matter because it had no client.

The Court stressed to counsel the importance of treating the Court with dignity and not abandoning pleadings, especially after asking for a continuance. The Court then issued an order for hearing on sanctions against Litton and the holder of the note.

At the hearing on March 2, Litton testified about the transfer of the loan. The Court stressed that appearing in federal court was not a trivial matter and that once a party had filed a pleading, it was not appropriate simply to disappear. The Court did not impose sanctions but did warn that it would take stronger action if parties did not act appropriately before the Court.

The Court sees similarities to the case at bar because Barrett Burke appeared in court through local counsel who was inadequately informed, who was not fully authorized, and who asked for a continuance on representations that ultimately proved to be not correct. The Court did not impose sanctions, but tried to provide guidance to counsel and to give counsel an opportunity to comply in the future.

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[9] Case No. 04-50312, Doc. # 45.

[10] *Gaytan*, *infra*, occurred at the same time as *Cordova*.

e. *In re Gaytan*, Case No. 04-50242 (Bankr. S.D. Tex. 2005)

Barrett Burke filed a motion to lift the automatic stay on behalf of Wells Fargo Bank, N.A. The motion alleged that the debtors were delinquent on five payments. The debtors filed a response alleging that they were current on the mortgage. The debtors attached a payment history they had received from Wells Fargo as well as a payment history that was downloaded from Wells Fargo's website. Barrett Burke did not file a rejoinder, nor did it appear at the hearing. Debtors' counsel appeared at the hearing and explained to the Court that he had been in communication with Barrett Burke regarding the payment discrepancies in the motion.

The Court issued an order to show cause why sanctions should not be imposed, stating that seven factors raised substantial concern about whether Barrett Burke had prepared the motion for relief from the stay with sufficient care and that the quality of the pleading raised substantial concerns about Barrett Burke's practice before the court: (i) the motion is largely boilerplate, (ii) the motion obviously contained typographical errors, (iii) the allegations of the motion appeared to be contrary to Wells Fargo's own documents relating to payments, (iv) Wells Fargo and Barrett Burke had not responded to the allegations in Debtors' response indicating that payments were current and Barrett Burke had not appeared at the hearing on its motion, (v) the motion alleged lack of insurance, but the debtors filed a response indicating that insurance was in place from February 2004 through February 2005, (vi) the motion alleged that there was no equity in the collateral and that Wells Fargo was not adequately protected, but the allegation appeared to be mere boilerplate, not thoughtful pleading, and (vii) the motion alleged that copies of the note and deed of trust were attached, but they were not.

Barrett Burke filed a response asserting that it had relied on its client's records. Wells Fargo filed its response requesting the Court allow it to withdraw its motion. At the February 3 hearing, the Court allowed Barrett Burke to orally withdraw the motion. Barrett Burke reported that Wells Fargo had settled the debtor's request for sanctions by agreeing to pay $1,500. Barrett Burke explained to the Court that they filed the pleading based on information in the referrals that clients give to them; they did not have access to the client's records. Wells Fargo allegedly had given Barrett Burke a flawed referral that had not been reconciled. Barrett Burke stated that it did not attend the hearing because it had brought the problem to Wells Fargo's attention but had not received a response prior to the scheduled hearing date.

The Court stated on the record that it was not convinced that the quality of the pleadings was adequate. The Court stressed that pleadings need to be accurate, thoughtful, and carefully reviewed before they are filed. Because the matter was settled, the Court decided to pursue no further action except to require Barrett Burke's managing partner to read the transcript of the hearing and to file a statement into the record confirming that the transcript had been read and that the firm's efforts in filing motions to lift the stay would be improved in the future.[11] Barrett Burke filed its statement on February 28, 2005, signed by Mary Daffin.

[11] Wells Fargo was also ordered to read the transcript and file a similar statement. Wells Fargo filed a statement with the Court acknowledging the error it made regarding the referral of the loan for a motion for relief from stay and the information contained in the referral.

The Court sees similarities to the case at bar not so much in that the initial pleadings were obviously seriously defective but in that Barrett Burke failed to correct the confusion prior to the hearing and even failed to appear at the hearing on its motion. The failure to appear at a hearing is not excused by the failure to receive a reply from the client. The case, again, demonstrates that warnings were provided; sanctions were not immediately imposed.

f. *In re Anderson*, Case No. 05-30161, 330 B.R. 180 (Bankr. S.D. Tex. 2005)

On February 22, 2005, a proof of claim was filed on behalf of CitiFinancial Mortgage Company. The proof of claim asserted that the claim was secured, but no documentation was attached to the proof of claim as required by FRBP 3001.[12] On May 24, 2005, Debtor's counsel objected to the proof of claim and served a copy of the objection and notice of hearing on CitiFinancial at the address listed in the proof of claim. On June 16, 2005, Barrett Burke filed an objection to confirmation of the chapter 13 plan on behalf of CitiFinancial.[13]

An attorney from Barrett Burke made an appearance at the confirmation hearing on behalf of another client, but Barrett Burke did not make an appearance to prosecute the objection to plan confirmation that Barrett Burke had filed on behalf of CitiFinanicial and the attorney for Barrett Burke who was present at the hearing on behalf of another client did not prosecute that objection. Nor did Barrett Burke file a timely response to Debtor's objection to the CitiFinancial claim or make an appearance at the hearing in response to that objection. The Court issued an order disallowing the claim.

Barrett Burke then filed a response to the objection on June 23, three days after the hearing and after the Court had signed an order disallowing the claim. Barrett Burke also filed a Motion to Vacate the Court's order. At the hearing on the Motion to Vacate Barrett Burke presented oral argument about the nature of CitiFinancial's alleged lien and about the equities of the situation, but Barrett Burke failed to introduce any evidence into the record concerning why its attorney failed to represent CitiFinancial at the June 20 hearing. Nor did Barrett Burke present any evidence concerning why documentation was not attached to CitiFinancial's claim. Judge Bohm denied the Motion to Vacate. No sanction was imposed, although the Court expressed its concerns in a memorandum opinion.

The Court sees similarities to the case at bar in failure to appear before the court at hearings on pleadings that Barrett Burke has itself filed.

g. *In re Clansy*, Case No. 04-40504 (Bankr. S.D. Tex. 2005)

Barrett Burke filed a motion for relief from stay on behalf of Washington Mutual Bank alleging that, through the Month of October, 2005, the debtors were one payment delinquent in

[12] Although the record does not indicate that Barrett Burke prepared the proof of claim, in a number of hearings in other cases Barrett Burke has testified that it regularly prepares the proofs of claim for clients but has clients sign the proof of claim. In any event, Barrett Burke did file an objection to plan confirmation on behalf of CitiFinancial as indicated below.

[13] Docket # 24.

payment of a secured claim.[14] About two weeks later, Barrett Burke filed an amended motion that was virtually identical with the first, except that it alleged that debtors were four payments delinquent through October, 2005. The debtors filed a response asserting they had paid all post-petition payments and had commitments to refinance the subject real property. At hearing on November 22, Barrett Burke presented no documents and called no witnesses in support of the motion. Barrett Burke requested a continuance on the grounds that its client had not provided requested documentation. The motion was dismissed with prejudice for sixty days.

The Court issued an order for Washington Mutual and its counsel to show cause why sanctions should not be imposed, expressing concern that the allegations of the motion were without factual basis.

At the hearing on December 6, an attorney from Barrett Burke testified that he had made a mistake in entering information into the system that generates the forms. He further stated that contrary to his prior representation to the court, he had indeed received a payment history from the client prior to filing the motion, and that the debtors had failed to make 2 payments:[15] August and September 2004. Judge Bohm found the pleadings to be confusing and misleading. He requested on the record that Barrett Burke draft its pleadings more precisely. Although he concluded that the error was not deliberate, he warned Barrett Burke to be more careful in its drafting. No sanctions were pursued.

The similarity with the case at bar is that Barrett Burke filed pleadings that were not only confusing and incorrect, they were contrary to the information in Barrett Burke's own file. In addition, the reason given for requesting a continuance was simply wrong. Finally, like the case at bar, the testimony was that the two erroneous motions were filed because data was incorrectly entered into a computer system, suggesting that somehow that attorneys have limited authority for the form of the pleadings. The testimony suggests that the computer system produces pleadings from the data that is entered.[16] The Court's warning was the only consequence to Barrett Burke.

h. *In re Porcheddu*, Case No. 05-40177, 338 B.R. 729 (Bankr. S.D. Tex. 2006)

Barrett Burke filed a motion for relief from stay on behalf of Chase Home Finance, LLC. At hearing on October 21, a Barrett Burke attorney testified in support of attorney fees requested by Barrett Burke. The attorney testified that the proffered fee statements were contemporaneous business records, that said attorney was the custodian of the records, and that time entries were made on a contemporaneous basis. Barrett Burke later acknowledged that all of the testimony was wrong. The fee statements were not business records of Barrett Burke; they were prepared in anticipation of litigation. The attorney was not the custodian for the records and had no idea how the records were maintained, and the time entries were not maintained on a contemporaneous basis. Barrett Burke never admitted to any wrong-doing in *Porcheddu*. The

[14] Docket # 233.

[15] Not one, as stated in the first motion, or four as stated in the amended motion.

[16] This is very similar to the testimony in the case at bar concerning the initial pleading that Barrett Burke filed in this case. *See* the Court's prior memorandum opinion.

Court noted "Barrett Burke recognizes the seriousness of this Court's show cause order. But what is most puzzling to the Court is that Barrett Burke fails to appreciate what is wrong with the approach they have taken and how fundamentally it distorts our adversarial system." *In re Porcheddu*, 338 B.R. 729, 737 (Bankr. S.D. Tex. 2006). The Court concluded that a sanction of $65,000 against Barrett Burke and $1000 against the individual attorney was an appropriate sanction.

The activity addressed in *Porcheddu* occurred in late 2005. The opinion was issued in February 2006. Barrett Burke has testified that it began investing money in its Default.Net custom software shortly thereafter. Barrett Burke also hired Ms. Marilee Madan as head of the bankruptcy attorneys in the firm, directly responsible for supervising those attorneys and resolving difficult problems. Ms. Madan began working with the firm in April. The conduct for which sanctions are imposed in this memorandum occurred over a period of time, commencing at least six months later.

2. Whether the responsible person is trained in the law

Barrett Burke is a law firm with 400 employees, about 35 to 40 of whom are attorneys. Barrett Burke is trained in the law.

3. What amount of monetary sanctions, given the financial resources of the offending party, will be sufficient to deter a repetition of similar conduct

a. Barrett Burke's contentions

Counsel for Barrett Burke, and Mary Daffin (Barrett Burke's managing partner) assure the Court that Barrett Burke "gets it".

> "The point is loud and clear."[17]

The essence of Barrett Burke's presentation is that they have undertaken substantial corrective action, and therefore punitive measures are not necessary.

*i. Quality Control*

Ms. Daffin testified that Barrett Burke began looking at supervisory controls prior to the order issued in *Porcheddu.* She hired Ms. Marilee Madan in March 2006 who began work about April 1 as the "managing bankruptcy attorney." Ms. Madan's compensation package is $500,000. Ms. Madan is in charge of day to day decisions, supervises attorneys, and provides training to attorneys (including bringing in training from outside of the firm).

Ms. Daffin estimates that Barrett Burke files 25,000 - 30,000 pleadings per year consisting of proofs of claim, motions to lift stay, objections to confirmation, and responses to contested matters. The process is electronic and contains multiple layers of security. The electronic file contains documents from the client such as the referral, loan documents, note,

[17] Transcript from March 22 hearing, p. 12, ln. 11-12.

deed of trust, payment history and any assignments of note or deed of trust. The file also has the debtor's schedules, petition, plan and any correspondence from Barrett Burke. To prepare pleadings, an attorney first reviews the file, looks at the documents, and determines whether the client's objectives are appropriate. After that review, there is a second level, to verify accuracy (described in more detail below). Barrett Burke uses a proprietary software system, Default.Net, that is personalized to each attorney who uses it. Since February 2006 Barrett Burke has invested $296,000 to improve its system.[18]

*ii. Payment Application and Claims Tracking ("PACT")*

Barrett Burke initiated dialogues between the members of the mortgage banking industry, major loan servicers, and others about trying to work together to track note payments on notes in bankruptcy cases. Barrett Burke testified that this task is made more complicated because each chapter 13 trustee uses a different system to make payments. These discussions led Barrett Burke to develop PACT, an electronic system to track payments and claims. Barrett Burke is the only firm that has invested money to develop PACT. The investment to date exceeds $900,000. Ms. Daffin expects phase two of PACT to cost $2 million. Ms. Daffin testified there are no current plans to market the PACT program, but the firm has not closed the door to marketing the program as a separate source of revenue.

*iii. Post-Allen Initiatives*

Barrett Burke testified that it has implemented the following changes to its processes.

Final Attorney Document Review – Each attorney must make one final review of a document to ensure accuracy. The attorney must certify within the system that he or she has completed this review. The system rejects the document that the attorney produces unless this documentation is made.

Objections to Confirmation – An attorney must review the debtor's plan and schedules, prepare a proof of claim, and prepare a plan review sheet. A second attorney reviews the plan and objection, and decides whether to object to the plan.

Recruiting New Positions – Barrett Burke is recruiting for a head of their new "objections to confirmation unit" and a hearing coordinator. Barrett Burke has also brought in a new executive to provide a business perspective.

"Brister Initiative" – Barrett Burke has employed Bill Brister, a former bankruptcy judge, as an independent auditor to examine Barrett Burke's bankruptcy processing. A preliminary report has been prepared by the auditor and reviewed by the Court.[19]

Training and Firm-imposed CLE – In addition to CLE required by the State Bar of Texas, Barrett Burke offers training through Ms. Madan every two weeks. This oral training is supplemented by a computer system designed to improve retention of the training. Separate

[18] *Id.* at p. 38.
[19] Document #109.

modules of training are designed for the attorneys and non-attorney staff. Barrett Burke began this training after *Porcheddu* but has emphasized it after the case at bar. The cost to the firm is $575 per employee for the license and $1,250 per module. The cost for 2006 was $110,000 but is expected to increase due to development of additional modules. Ms. Madan is also responsible for bringing in additional training by people not associated with the firm.

Client Affidavits – The Bankruptcy Court for the Southern District of Texas is unique in that it is the only district that has not required attorneys to have their clients sign affidavits concerning their records that support various motions. Out of an abundance of caution, Barrett Burke will now require affidavits of all clients.

Supervision – New attorneys are being recruited for supervision. Certain complex matters will not be filed without Ms. Madan's approval.

Withdrawal – Withdrawal of a pleading will require approval by Ms. Daffin and must be accompanied by specific language as to the circumstances and the reason for the withdrawal.

Termination of Attorneys – Barrett Burke has terminated the employment of two attorneys.

b. Are Barrett Burke's efforts adequate?

It is clear that Barrett Burke is focused on its problems and is making substantial efforts to resolve them. The Court has every hope that those efforts will be successful. Because of these efforts, the Court has substantially reduced its initial estimate of the quantum of sanctions that might be necessary to deter future repetition of the practices set out above. Nevertheless, the Court believes that some substantial sanction is required for that purpose.

First, as indicated above, Barrett Burke had numerous warnings prior to the imposition (at least in this district) of monetary sanctions. Yet by Barrett Burke's own testimony, it did not undertake substantial effort until the substantial monetary sanction in *Porcheddu*. Second, Barrett Burke seems to continue to focus on checklists and decision-trees as the solution of the problems, and ignores the fact that there is simply no substitute for a thoughtful, conscientious attorney reading a pleading and asking whether a pleading makes sense; there is no substitute for correcting errors timely after they occur, and there is no excuse for failing to provide well-informed attorneys at hearings on the motions that Barrett Burke files.[20] The attorneys must be fully authorized to represent the client and to provide correct information to the court. The purpose of the sanctions imposed by the Court in this memorandum is to make that point, as *Porcheddu* made a different point.

*i. The testimony*

Barrett Burke estimates its hard costs alone at $2 million, post-*Porcheddu*. But, as the US Trustee pointed out, this testimony is exaggerated.

[20] *See* footnote 1 above.

First, Ms. Daffin's testimony did not give adequate breakdown of these costs. She remembered many of the large numbers, but she did not adequately explain which of these expenses were expenditures routinely incurred in the practice of law (such as software costs or CLE expenses) and what expenses were directly attributable to corrective action. In addition, it was clear that the cost of developing PACT software (almost half of the expenditures) is an independent project, possibly with independent profit potential through sale/license to other entities. PACT is irrelevant to what happened in the case at bar. Ms. Madan testified that it would not have prevented what happened in this case.

Ms. Madan was hired more than five months prior to Barrett Burke filing its initial pleading in the case at bar. And she was clearly on board in a supervisory position when the error was made, when the error was not corrected, and when a grossly incorrect "withdrawal" was filed. She was firmly in place when Barrett Burke failed to send informed and authorized attorneys to the hearing, even after a problem had been identified. The problem in the case at bar festered for months after Barrett Burke filed the initial pleading, and there was plenty of time, and warning by the Court on the record, for supervisory counsel to confront and to correct the situation. Walter Thurmond, another supervisory attorney at Barrett Burke, was aware of the situation in detail. The supervisory structure does not seem to have addressed the situation.

While the absolute dollar amount of Barrett Burke expenditures is not convincing, Ms. Daffin and Ms. Madan were obviously sincere in their statements of their recognition of a serious problem and their intent to address it.

Barrett Burke's efforts to date are oriented toward checklists and levels of security for mass production of pleadings. In their testimony, Ms. Daffin and Ms. Madan discussed decision protocols and certifications that an attorney must make to the law firm before filing a pleading. The checklist[21] for filing a motion for relief from the stay, for example, has about 57 items that the filing attorney must address before filing a motion to lift stay. Nowhere in the checklist is the attorney required to read the motion and to ask himself or herself whether the motion (as written) makes sense or whether it accurately reflects the facts and law. While the checklist asks the attorney to double-check and to certify that the numbers in the pleading are right, it does not ask the attorney to consider whether the pleading makes sense. In other words, nowhere is the attorney required to "stop and think"[22] before filing a pleading.

The checklists and the firm's orientation, as Ms. Madan's testimony indicates, are oriented around decision-making. They have little or no reference to drafting pleadings that convey information or that simply make sense. The US Trustee's cross examination suggested that the pleadings are "rough drafted" by computer or by paralegal for review by attorneys. That seems to comport with the evidence at the hearing in Victoria in which Ms. Sanov testified that she filed a meaningless pleading because she entered the wrong computer code. It also comports with the testimony in *Clansy, supra*, in which Barrett Burke explained defective pleadings by stating that data had been incorrectly entered into the computer that generates the forms.

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[21] Barrett Burke Exhibit 9.

[22] "As stated by the Advisory Committee Note to Rule 11, a lawyer is required to " 'stop-and-think' before... making legal or factual contentions." *Jenkins v. Methodist Hospitals of Dallas, Inc.*, 478 F.3d 255 (5th Cir. 2007).

Checklists and decision trees do not address whether a pleading makes sense in context and whether it communicates the firm's position to opposing counsel and to the Court. No checklist or decision protocol will replace the judgment of a conscientious attorney who simply reads the pleading and asks whether it makes sense.

ii. *In re Gomez*, Case No. 06-50239 (Bankr. S.D. Tex. 2007)

The hearing on the amount and nature of sanctions in the case at bar was March 22, 2007, over a year after *Porcheddu*. At that March 22 hearing, Ms. Daffin and Ms. Madan testified about the corrective actions that had been taken to assure that the problem in this case would not recur.

In *Gomez,* on February 28, three weeks prior to Ms. Daffin's and Ms. Madan's testimony. Barrett Burke filed a motion to lift stay on behalf of America's Servicing Company. Barrett Burke amended the motion on March 26, four days after Ms. Daffin's and Ms. Madan's testimony. The initial motion stated that Debtor was delinquent on post-petition note payments in the amount of $1,748. The amended motion stated that the post-petition delinquency was $5,881. At the hearing, local counsel appeared on behalf of Barrett Burke and reported that a continuance was necessary because the creditor had initially believed the debtor was three payments delinquent, but later discovered the debtor was nine payments delinquent. Virtually none of that was correct.

When it was all straightened out, at a hearing on April 26, the Court learned that the Debtor was indeed delinquent for post-petition payments of $1,748, but that there were pre-petition defaults on taxes and/or other charges that increased the deficiency. The statement, made by local counsel in open court that the debtor was delinquent for nine post-petition payments instead of three was obviously incorrect; the error was obvious, because the debtor had only been in bankruptcy for five months and could not possibly have been delinquent for nine monthly payments. Barrett Burke vigorously asserts that it bears no blame for the confusing pleading in *Gomez* because the problem was caused by the Court's confusing form. Even if that were correct,[23] the fact remains that Barrett Burke sent local counsel to a hearing without adequate information and authority and, through local counsel, asked for a continuance on allegations that have no basis in fact.

*iii. Conclusion—Barrett Burke has made a good start*

The Court agrees that Barrett Burke has made extensive efforts and has expended substantial sums. But the Court cannot conclude, as Barrett Burke suggests, that no sanctions are necessary to deter future violations of the rules. Barrett Burke has simply had too many warnings and has promised improvement before.

[23] While the Court agrees that the form could be improved, the central point remains. Counsel should have read the pleading, and if it did not make sense in context, should have availed himself of the provision in the local rules to submit a "nonstandard" motion. Obviously counsel knew how to do this, since he actually asked for a variance with respect to paragraph 1 of the form. *See* the Court's memorandum, docket # 63. Counsel is not credible when he acknowledges that he knew how to ask for a variance from local procedures with respect to paragraph 1 but failed to be accurate in paragraphs 11 and 12 because the form made him do it. See docket # 63 in case # 06-50239 for more detail.

Therefore the Court looks to the factors that it must address to determine the amount of sanctions.

c. Barrett Burke's Financial Resources

One of the factors that the Court must consider is the magnitude of the attorney's financial resources. The US Trustee asked for discovery that would include Barrett Burke's financial statements. Barrett Burke aggressively resisted that discovery, and the Court acceded to Barrett Burke's position to avoid causing Barrett Burke any more distress than was absolutely necessary. Barrett Burke argued long and hard that the Court's earlier memorandum opinion had caused Barrett Burke great difficulty in relations with its clients and with relationships in the bar. Mr. Thomas testified that the bar had viewed the opinion as "Schadenfreude" or "the gleeful joy at the misfortune of others." The Court spared Barrett Burke an extensive and public disclosure of its finances. But there is considerable evidence on the record that would sustain a conclusion that Barrett Burke's financial resources are quite substantial.

Barrett Burke testified that it has 400 employees, and Barrett Burke's counsel stated that between 35 and 40 of those employees are attorneys. Counsel did not state how many of those are partners and how many are staff attorneys. The compensation package for Ms. Madan, supervisor of the bankruptcy attorneys, is $500,000 per year. Barrett Burke files 25,000 to 30,000 pleadings per year. The Court allows $650 as reasonable compensation for the most common of those pleadings, motions to lift stay. If one assumes that Barrett Burke averages about $387 per pleading, then its gross income from bankruptcy pleadings alone is between $9,675,000 and $11,610,000.[24] Counsel for Barrett Burke has steadfastly maintained, and Ms. Daffin generally substantiated, that Barrett Burke has spent over $2 million in the past year on computer programs, continuing education, related employee training, and Ms. Madan's compensation package.

## IV. CONCLUSION

There is no objective or scientific way to determine the nature of sanctions that should be imposed or to calculate the amount of sanctions that should be imposed.

Barrett Burke's testimony indicated that *Porcheddu* was the seminal event in its efforts to address deficiencies in its practice. But the discussion above establishes that Barrett Burke had been warned many times, prior to *Porcheddu*, about problems in its practice. Barrett Burke did

[24] The Court notes that Barrett Burke was receiving $125 for filing proofs of claim in 2002. *In re Slick*, Case No. 98-14378, Adv. 99-1136, 2002 Bankr. LEXIS 772 (Bankr. S.D. Ala. 2002). (Presumably that figure has increased substantially in the past 5 years.) So the Court concludes that the least expensive of these pleadings probably produces substantially more than $125. The Court in other matters has determined that $650 is a reasonable fee for filing motions to lift stay (the most common pleading of those that Ms. Daffin included in the 30,000 annual pleadings). The average of $650 and $125 is $387.50. Although the Court would be highly surprised if Barrett Burke does not receive more than an average of $387 for the 30,000 pleadings it files annually, the Court will use that figure because Barrett Burke so strenuously resisted disclosing specific figures. The firm has other business in addition to filing bankruptcy pleadings. Therefore the Court concludes that gross revenues would be substantially in excess of $10,000,000 per year.

not provide evidence of the commencement of efforts to address deficiencies prior to the imposition of a substantial monetary sanction in *Porcheddu*. The Court concludes that monetary sanctions have been effective where warnings and signals have not. Therefore, the Court concludes that monetary sanctions are necessary.

There was no persuasive evidence that the $2 million expenditures that Barrett Burke testified as having been made post-*Porcheddu* adequately focused on the problems raised in the prior cases or in the case at bar. As noted above, those expenditures are substantially, (if not principally) for the ordinary costs of business: maintaining a sophisticated computer system, developing a new system that is potentially marketable independent of the firm's law practice, and generally administering a law firm with 400 employees.

And Barrett Burke testified that its efforts were responsive to *Porcheddu*, which Barrett Burke views as a problem of "false statement to the court" as opposed to a problem of inadequate pleadings and practices. Despite warnings, Barrett Burke did not adequately address those latter issues pre-*Porcheddu*, and the evidence is that the issues were not substantially addressed until after the findings in the case at bar. For example, Barrett Burke testified that it is looking for a supervisory lawyer to coordinate appearances at hearings, but that lawyer is not yet on board, and it was not clear what the focus of that new supervisor would be. Would it be simply to assign a lawyer to attend a hearing or would it be to assure that fully informed, fully authorized attorneys attend hearings. As late as *Gomez* that issue was not resolved. And Barrett Burke did not hire former judge Brister until this Court asked how substantial the sanction would have to be in order to deter repetition of the conduct. Therefore the Court concludes that further sanctions are necessary to make the point on the issues of incorrect, incomprehensible pleadings and failure to attend hearings, or sending counsel to hearings ill-informed and unprepared to prosecute the matter for hearing.

Having determined that sanctions are necessary, and that the sanctions must be monetary, the Court must determine what amount of monetary sanction is appropriate. The Court concludes that the amount of sanctions must be substantial, greater than the amount in Porcheddu ($65,000). The sanctions must also be proportionate. Although Barrett Burke aggressively resisted disclosure of firm financial information, the evidence indicates that its revenues from bankruptcy pleadings similar to those at issue are between $9,675,000 and $11,610,000 annually. Expenditures for computer software, continuing education, and other related costs exceed $2 million. Compensation to the senior bankruptcy supervising attorney is $500,000. The Court concludes that $150,000 is a substantial amount, and is proportional as an amount that is less than 2% of revenues from filing bankruptcy pleadings (which is substantially less than total revenues), about 7.5% of computer software and CLE costs, about 30% of a single attorney's compensation package, and about 10 times the very conservative estimate of the costs and expenses of Barrett Burke's conduct.

Therefore the Court believes that the appropriate amount of sanctions in this case is $150,000. However, because Barrett Burke recognizes the gravity of its actions and takes responsibility for those actions, and to recognize Barrett Burke's current intensity in addressing its deficiencies, the Court remits half of that sanction and imposes a sanction of $75,000.

Let this be clear. No one suggests that Barrett Burke is not allowed to make mistakes. Filing 30,000 bankruptcy pleadings per year, mistakes will occur.

What is required, first, is that a careful, thoughtful attorney must review a document before it is filed and assure not only that the numbers are accurate, but also that the document makes sense, on its face, and communicates clearly and accurately the client's position. Second, if a mistake is made, a thoughtful, clearly articulated correction must be filed into the record, not a meaningless form. The correction must be timely and must be filed without the need for a party to seek coercion. Third, Barrett Burke must send to the hearings on its motions an attorney who is fully informed and authorized to resolve the matter at the hearing, or if resolution of the matter at the hearing is not possible, the attorney must at least inform the court clearly and correctly what the problem is.

The sanction is imposed by separate order issued this date.

SIGNED 06/18/2007.

Wesley W. Steen

WESLEY W STEEN
United States Bankruptcy Judge

# Misbehavior and Mistake in Bankruptcy Mortgage Claims

Prof. Katherine Porter
University of Iowa


Abstract

The greatest fear of many families in serious financial trouble is that they will lose their homes. Bankruptcy offers a last chance for families to save their houses by halting a foreclosure and by repaying any default on their mortgage loans over a period of years. Mortgage companies participate in bankruptcy by filing proofs of claims with the court for the amount of the mortgage debt. In turn, bankruptcy debtors pay these claims to retain their homes. This process is well-established and, until now, uncontroversial. The assumption is that the protective elements of the federal bankruptcy shield vulnerable homeowners from harm.

This Article examines the actual behavior of mortgage companies in consumer bankruptcy cases. Using original data from 1700 recent Chapter 13 bankruptcy cases, I conclude that mortgage servicers frequently do not comply with bankruptcy law. A majority of mortgage claims are missing one or more of the required pieces of documentation for a bankruptcy claim. Fees and charges on claims often are poorly identified, making it impossible to verify if such fees are legally permissible. In nearly all cases, debtors and mortgage companies disagree on the amount of outstanding mortgage debt.

Despite these irregularities, mortgage claims in bankruptcy are infrequently contested. Imposing unambiguous legal rules does not ensure that a system will actually function to safeguard the rights of parties. The findings are a chilling reminder of the limits of formal law to protect consumers. Observing the reality that laws can underperform has crucial implications for designing legal systems that produce acceptable and just behavior and for evaluating the appropriate scope of consumer protection.

For bankrupt families, misbehavior or mistake by mortgage servicers can have grave consequences. Undocumented or bloated claims can jeopardize a family's ability to save their home in bankruptcy. Beyond bankruptcy, poor or abusive mortgage servicing undermines America's homeownership policies for all families trying to buy a home. This Article's data offer an empirical measure of the validity of concerns about whether consumers can trust mortgage companies to adhere to applicable laws.

# Misbehavior and Mistake in Bankruptcy Mortgage Claims

Katherine Porter*

Abstract

*The greatest fear of many families in serious financial trouble is that they will lose their homes. Bankruptcy offers a last chance for families save their houses by halting a foreclosure and by repaying any default on their mortgage loans over a period of years. Mortgage companies participate in bankruptcy by filing proofs of claims with the court for the amount of the mortgage debt. In turn, bankruptcy debtors pay these claims to retain their homes. This process is well-established and, until now, uncontroversial. The assumption is that the protective elements of the federal bankruptcy shield vulnerable homeowners from harm.*

*This Article examines the actual behavior of mortgage companies in consumer bankruptcy cases. Using original data from 1700 recent Chapter 13 bankruptcy cases, I conclude that mortgage servicers frequently do not comply with bankruptcy law. A majority of mortgage claims are missing one or more of the required pieces of documentation for a bankruptcy claims. Fees and charges on claims often are poorly identified and do not appear to be reasonable. The bankruptcy data reinforce concerns about the overall reliability of the mortgage service industry to charge homeowners only the correct and legal amount of the debt and to comply with applicable consumer protection laws. Mistakes or misbehavior by mortgage servicers can have grave consequences. Bloated claims can jeopardize a family's ability to save their home in bankruptcy. On a system level, mistakes or misbehavior by mortgage servicers undermine America's homeownership policies for all families trying to buy a home.*

*The data also reinforce concerns about whether consumers can trust financial institutions to adhere to applicable laws. The findings are a chilling reminder of the limits of formal law to protect consumers. Imposing unambiguous legal rules does not ensure that a system will actually function to safeguard the rights of parties. Observing the reality that laws can underperform or even misfire has crucial implications for designing legal systems that produce acceptable and just behavior.*

* Associate Professor of Law, University of Iowa. I thank the National Conference of Bankruptcy Judges' Endowment of Education for funding this research, Tara Twomey for her participation as co-investigator in developing the Mortgage Study database, and Ann Casey for invaluable empirical assistance at every point in this project. John Eggum, Sarah Hartig, Chris Jerry, Gina Lavarda, Brian Locke, and Nece McDaniel provided research assistance. This paper benefited from the feedback of participants at the Harvard-University of Texas Joint Conference on Empirical Law Realities and from the comments of Robert Lawless, Lynn LoPucki, Ronald Mann, and Elizabeth Warren.

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## INTRODUCTION

Families in financial distress are under great stress. The telephone rings with repeated calls from debt collectors, each paycheck is at risk of garnishment, and the next knock on the door could be a process server or a repo agent. For many families, the greatest fear is losing their home to foreclosure. A home is not only most families' largest asset, but also a tangible marker of their financial aspirations and middle class status. A threatened or pending foreclosure can signal the end of a family's ability to struggle against financial collapse and an unrecoverable tumble down the socioeconomic ladder.

Bankruptcy offers these families one last chance to save their homes.[1] A bankruptcy filing halts a pending foreclosure and gives families the right under federal law to cure any defaults on mortgage loans over a period of years. The bankruptcy system offers refuge from the vagaries of state law foreclosure, substituting the protections of a federal court system and uniform legal rules to ensure that these families get one final opportunity to preserve their homes.

But this protection comes at a cost. Mortgage companies file proofs of claim with the bankruptcy court for the amount of the mortgage debt. In turn, bankrupt debtors must pay these claims or lose their homes. The balance between the family and the mortgage lender is clearly spelled out in the bankruptcy laws, specifying the manner in which the amount owed is to be established and obligating both the homeowner and the mortgage company to disclose information accurately.

This claims process is well-established and, until now, uncontroversial. Homeowners—backed up by lawyers, policymakers, and news reporters—assume that bankruptcy functions according to the official rules and, by following these rules, that it provides a realistic opportunity for families to save their homes. The data revealed in this Article suggest, however, that home mortgage lenders often disobey the law and overreach in calculating the mortgage obligations of consumers. Such actions can cripple a family's efforts to save its home and undermine policies to promote sustainable homeownership.

This Article examines the actual behavior of mortgage companies in the consumer bankruptcy system. Using original data from 1700 recent Chapter 13 bankruptcy cases, I conclude that mortgagees' behavior significantly threatens bankruptcy's potential to help families save their homes. Despite unambiguous federal rules designed to protect homeowners and to ensure the integrity of the bankruptcy process,[2] mortgage companies frequently fail to comply with the laws that governs bankruptcy claims. A majority of mortgage companies' proofs of claim lack the required documentation necessary to establish a valid debt. Fees and charges on bankruptcy claims often are identified poorly and sometimes do not appear to be reasonable. Each year, mortgage creditors assert that bankrupt families owe them an aggregate of at least one billion dollars more than the families themselves believe are their outstanding mortgage debts. Although infractions are frequent and irregularities are sometimes egregious, the bankruptcy system routinely

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[1] Raisa Bahchieva et al., *Mortgage Debt, Bankruptcy, and the Sustainability of Homeownership*, in CREDIT MARKETS FOR THE POOR 73 (Patrick Bolton & Howard Rosenthal eds., 2005) (stating that Chapter 13 bankruptcy is frequently used by families who face foreclosure).

[2] *See, e.g.*, *In re* Matus, 303 B.R. 660, 675 (Bankr. N.D. Ga. 2004) ("The [bankruptcy] statutes are designed to insure complete, truthful and reliable information is put forward at the outset of the proceedings, so that decisions can be made by the parties in interest based on fact rather than fiction.").

processes mortgage claims that are not lawful. Far from serving as a significant check against mistake or misbehavior, the bankruptcy system routinely processes mortgage claims that clearly are not lawful.

The data revealed here are important because they offer a rare glimpse into the billion-dollar world of mortgage servicing. Many of the overcharges and unreliable calculations identified in the bankruptcy data are not specific to bankruptcy. Instead, they raise the specter of poor recordkeeping, failure to comply with consumer protection laws, and massive, consistent overcharging. If mortgage companies frequently fail to comply with federal bankruptcy law and do not deal honestly with bankruptcy courts, trustees, and bankrupt families (most of whom are represented by attorneys), the problems may be worse for ordinary, non-bankrupt Americans, who have none of those safeguards operating in their favor. These data suggest a widespread problem in the American home mortgage market. Instead of focusing exclusively on loan origination, these data suggest that regulators and policymakers should broaden their vision to consider how poor mortgage servicing can threaten families' efforts at homeownership throughout the country.

The evidence that unreliable mortgage servicing is flourishing also provides a powerful lesson on the limits of formal law. The procedures for bankruptcy claims were thoughtfully designed to balance the concerns of consumers and industry. All parties usually are represented by attorneys. A specialized federal bench and neutral bankruptcy trustees are appointed specifically to police misbehavior. The system has functioned for decades without generating calls for reform. Yet, these data show that reality is far from the ideal suggested by these external markers of system reliability. The findings are a chilling reminder that imposing unambiguous legal rules does not ensure that the system will actually function to safeguard the rights of parties. In a consumer context in particular, where individuals are not repeat players or institutional actors, observing the reality of laws that underperform or even misfire has crucial implications that echo far beyond the bankruptcy scheme. An effective legal system requires more than merely putting words in a statute or relying on silence as an indication of acceptable and just behavior. These data show that effective enforcement mechanisms or structural incentives for compliance can be as important as the substantive rules themselves.

Part I of this Article examines the incentives for mortgage servicers to comply with applicable laws and describes reported incidences of abusive servicing. Part II describes the methodology of the Mortgage Study. Part III presents original data on the legality and accuracy of mortgage claims. These data show that even in the context of the heightened procedural protections in bankruptcy, the incidence of unreliable servicing behavior is high. Part IV analyzes the policy implications of my findings and proposes structural solutions to reduce the risks to homeowners created by poor servicing. Without improved procedures and enforcement activity, families struggling with homeownership—both inside and outside bankruptcy—remain vulnerable to mortgagees' mistakes and misbehavior.

## I. STATEMENT OF PROBLEM

Many Americans pursue homeownership as a step to build wealth and to improve their financial position. As the volume of mortgage lending has mushroomed and the secondary mortgage market has matured, there have been occasional criticisms of mortgage servicing.[3]

[3] Some lenders service their own loans. For purposes of this paper, I refer only to servicers, but lenders who service their own loans may engage in similar behavior to third-party servicers.

Consumers have complained of overcharges or difficulty in obtaining accurate loan information. Friction between mortgagors and mortgagees (and their agents) has sometimes erupted into litigation, most frequently in bankruptcy courts. Although policymakers' focus has been on loan origination,[4] consumers also are harmed if they are overcharged while they are paying their mortgage. Mortgage servicing errors that lead to overcharges increase the cost of homeownership and expose families to the risk of wrongful foreclosure. Scattered reports reveal a range of possible mortgage servicing abuse and highlight the need for a systematic examination of such behavior.

**A. The Structure and Function of Mortgage Servicing**

Mortgage servicing is the collection of payments from borrowers and the disbursement of those payments to the appropriate parties such as lenders, investors, governments, and insurers.[5] The rise of servicing as a distinct industry results from the widespread use of securitization in the mortgage market.[6] Put simply, securitization is the process of creating debt instruments (usually bonds) by assembling a group of mortgage loans into a pool of similar transactions, transferring the obligations to a trust, and then selling investors fractional interests in the trust's pool of mortgages.[7] These investors receive periodic payments on their investments in the pool of loans. Servicers act as intermediaries between the borrower and the other parties to the securitization. A pooling and servicing agreement sets out the servicer's responsibilities for collecting and remitting the mortgage payments and the permissible responses that the servicer may employ if a borrower defaults on a loan. The participation of servicers complicates the borrower-lender relationship and limits flexibility in loss mitigation and default situations.[8]

Borrowers cannot shop for a loan based on the quality of the servicing, and they have virtually no ability to change servicers.[9] The servicer works on behalf of the bond issuer, and by extension the investors who owned the mortgage-backed securities. The servicer does not have a customer relationship with the borrower.[10] When they enter into a mortgage transaction, borrowers cannot specify that a particular servicer will be responsible for their loan. If their servicer provides poor or even abusive service, the borrower has no exit strategy other than

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[4] *See, e.g.*, Iowa Attorney General, Press Release, States Settle with Household Finance: Up to $484 Million for Consumers (Oct. 11, 2002), *available at* http://www.state.ia.us/government/ag/latest_news/releases/oct_2002/Household_Chicago.html (reporting settlement with Household Finance for misrepresentation and disclosure violations at loan origination was largest-ever direct restitution settlement).

[5] Kurt Eggert, *Limiting Abuse and Opportunism by Mortgage Servicers*, 15 HOUSING POLICY DEBATE 753, 755 (2004); Michael LaCour-Little, *The Evolving Role of Technology in Mortgage Finance*, 11 J. OF HOUSING RESEARCH 173, 186 (2000).

[6] Statement of Sheila C. Bair, Testimony before U.S. House Comm. on Financial Services, (April 17, 2007) ("Prior to the widespread use of securitization, home finance typically involved a bank or savings institution granting a loan to a borrower. The lending institution would make the decision to grant credit, fund the loan, and collect payments.").

[7] *See generally* Steven L. Schwarcz, Bruce A. Markell, & Lissa L. Broome, SECURITIZATION, STRUCTURED FINANCE, AND CAPITAL MARKETS (2004) (providing an introduction to securitization and examining the legal issues relevant to a securitized transaction).

[8] *Id.* at 9.

[9] Jack Guttentag, *Why is Mortgage Servicing So Bad?*, http://www.mtgprofessor.com/A%20-%20Servicing/why_is_servicing_so_bad.htm.

[10] Lenders do have a customer relationship with borrowers and may want to retain them as repeat customers. Some lenders retain the servicing obligations when they sell loans on the secondary market, but the active market for servicing contracts means that very few customers will find that their loan is serviced by the originating lender.

refinancing the loan. Even then, there is no guarantee that the refinanced loan will not be assigned to the same servicer. Consumers cannot seek redress by complaining about the quality of the servicing because the servicer's reputation among borrowers is not a concern for issuers. Neither the servicer nor the bond issuer has a financial incentive to care about service to a borrower.[11]

While servicers are limited in their actions by their contracts with the trust for the bond holders, servicers have a financial incentive to overcharge consumers. Mortgage servicers earn revenue in three major ways. First, they receive a fixed fee for each loan. Typical arrangements pay servicers between .25% and 1.375% of the note principal for each loan.[12] Second, servicers earn "float" income from accrued interest between when consumers pay servicers and when the servicers remit those funds to their clients. Third, servicers often are permitted to retain all, or part, of any additional charges that consumers pay.[13] Servicers boost their profits when they charge excessive fees, impose late charges, or create hurdles for borrowers who are trying to cure defaults and stop a cascade of fees.[14] The head of the Federal Deposit Insurance Corporation has noted that because of this structure, the servicers' incentives upon default may not align with bondholders' incentives.[15] A borrower's default can present a servicer with an opportunity for additional profit. A significant fraction of servicers' total revenue appears to come from retained fee income.[16]

A consumer is only obligated to pay charges if they are permitted by the terms of the mortgage and by state and federal law. To ensure the accuracy and legality of such charges, consumers must understand how the servicer calculated the amount purported to be due and whether such fees are consistent with their loan contract. Mortgage servicers may exploit consumers' difficulty in recognizing errors or overcharges by providing poor service that maximizes their profits.[17] A lending industry representative has admitted that "[m]ost people don't understand the most basic things about their mortgage payment."[18]

The Federal Trade Commission has identified mortgage servicing abuse as a serious problem for homeowners and urged consumers to keep careful records to ensure that their mortgage account is being properly credited.[19] Among the specific practices that the Commission has flagged are the imposition of unwarranted late fees; unnecessary force-placed insurance; and illegitimate or unexplained fees. Despite these alleged problems, the Commission has not targeted any particular servicer or servicing practice for enforcement activity in the last few years. Another federal agency, the Department of Housing and Urban Development, has potential authority to address servicing misbehavior. Forty percent of consumer complaints to the

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[11] *Id.*
[12] Nat'l Consumer Law Center, FORECLOSURES 23 (2006 Supp.).
[13] Eggert, *supra* note 15,. at 758 (explaining that servicers' conventional fee is a percentage of the total value of the loan but that servicers typically have the right to retain any default fees).
[14] Nat'l Consumer Law Center, *supra* note __, at 23.
[15] Statement of Sheila C. Bair, *supra* note ___, at 9.
[16] Some information can be gleaned from the securities filings of public companies that service mortgages. Late charges account for approximately 11% of revenues for Ocwen's residential mortgage servicing division in 2006. *See* Ocwen Financial Corp., Annual Report (Form 10-K), at 30 (Mar. 16, 2007). *Cf.* RONALD MANN, CHARGING AHEAD 23 (2006) (reporting that credit card issuers earn 9% of their revenue from penalty fees).
[17] *See* Jack Guttentag, *Why is Mortgage Servicing So Bad?*, http://www.mtgprofessor.com/A%20-%20Servicing/why_is_servicing_so_bad.htm (Feb. 3, 2003; updated Dec. 13, 2004).
[18] Lenders Look for Way to Avoid Bankruptcy Maze, NAT'L MORTGAGE NEWS, Aug. 30, 2004.
[19] Fed'l Trade Comm'n, Mortgage Servicing: Making Sure Your Payments Count, *available at* http://www.ftc.gov/bcp/conline/pubs/homes/mortgserv.htm.

Department of Housing and Urban Development concern servicing issues,[20] and a study of consumer satisfaction with business services found that only 10% of borrowers are happy with their mortgage servicer.[21] Yet, litigation outside of the bankruptcy context alleging mortgage servicing abuse is sparse. The paucity of lawsuits could have several explanations, including that consumers are not aware of their rights with regard to servicers, that attorneys are not willing to bring such lawsuits, or that most disputes are resolved without the need for litigation.

Mortgage servicing abuse is a nascent legal issue. Because mortgage servicing is a relatively new industry, the law has generally lagged behind emerging issues.[22] The Real Estate Settlement Procedures Act is the main federal law that governs mortgage servicers.[23] The thrust of that law is to obligate servicers to communicate certain information to borrowers.[24] Consumers may submit a "qualified written request" to obtain information about the servicing of their mortgages, and servicers are obligated to respond to the request within sixty days.[25] There is no empirical evidence of how frequently consumers invoke this law to aid them in their disputes with servicers, or whether consumer attorneys are aware of the potential of the Real Estate Settlement Procedures Act to aid clients struggling with mortgage servicing abuse.[26]

Newspapers have featured the difficulties that consumers face in resolving disputes with mortgage servicers.[27] Consumers allege that they have to speak with dozens of representatives to address servicing mistakes or to receive basic information such as a payment history. These problems are exacerbated when a borrower defaults on a loan, in part because the loan is often transferred to the loss mitigation department or sold to a different servicer. This year, the *Boston Globe* reported that mortgage companies include projected foreclosure costs in payoff amounts given to borrowers in default.[28] These fees are estimates for anticipated services that may never be incurred. While a consumer advocate described the practice as a "license to steal from homeowners," an industry representative conceded that it was "pretty much industry standard."[29]

Two cases illustrate the harms that incorrect or inaccurate mortgage servicing can impose on borrowers. In *Rawlings v. Dovenmuehle Mortgage, Inc.*,[30] the servicer repeatedly asserted that the homeowners had failed to make payments, imposed late fees, and sent notices of default. It took the consumers over seven months to resolve its error in applying the consumers' payments to another borrower's account. In *Islam v. Option One Mortgage Corp.*,[31] the prior servicer continued to contact borrowers who had refinanced their mortgage loan, threatened to foreclose

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[20] *See* Jack Guttentag, *Why is Mortgage Servicing So Bad?*, http://www.mtgprofessor.com/A%20-%20Servicing/why_is_servicing_so_bad.htm (Feb. 3, 2003; updated Dec. 13, 2004) (reporting that two in five complaints to the Department of Housing and Urban Development involve servicing issues).

[21] Press Release, J.D. Powers and Associates, *Customer Service and Attention to Detail Drive Home Mortgage Satisfaction* (Nov. 26, 2002), http://www.jdpower.com/corporate/news/releases/pressrelease.aspx?ID=2002144.

[22] Nat'l Consumer Law Center, *supra* note ___, at 23.

[23] 12 U.S.C. § 2605.

[24] For example, if the loan is being transferred to a different servicer, the consumer must receive timely notification of the transfer. 12 U.S.C. § 2605(b).

[25] 12 U.S.C. § 2605(e).

[26] One challenge may be that consumers do not seek counsel until foreclosure is imminent, at which time, a qualified written request and its sixty-day response window may not seem like an expedient option.

[27] *See, e.g.*, S.P. Dinnen, Mortgage Complaints Can Take Extra Effort, DES MOINES REGISTER, May 2, 2004; A. Pesquera, Paper Trail of Problems: Some Fairbanks Clients Report Nightmare Errors, SAN ANTONIO EXPRESS-NEWS, Aug. 9, 2002.

[28] Sacha Pfeiffer, *Hidden Legal Fees Push Some Into Foreclosure*, BOSTON GLOBE (Jan. 18, 2007).

[29] *Id.*

[30] 64 F. Supp. 2d 1156 (M.D. Ala. 1999).

[31] 432 F. Supp. 2d 181 (D. Mass. 2006).

on their home, and did not report to credit bureaus that the loan was paid off. The consumers struggled for more than a year to get the servicer to change its practices. These cases highlight the burden that consumers face in resolving disputes without resorting to litigation. Yet, the paucity of reported opinions suggests that many consumers may respond to mortgage claims by "lumping it," rather than seeking any formal redress.[32]

When problems are systematic, individual consumer action may be an ineffective solution. The Federal Trade Commission joined the National Consumer Law Center in bringing a class-action lawsuit against a large servicer, Fairbanks Capital Corporation, for alleged violations of consumer protection laws. The lawsuit settled in 2003 after Fairbanks agreed to pay $47 million, including funding a $5 million foreclosure-redress fund for consumers who lost their homes in part due to unwarranted charges or difficulties in obtaining information from Fairbanks.[33]

Spiking foreclosure rates and pressure from Wall Street may exacerbate problems with mortgage servicing.[34] Falling real estate prices have changed the profit calculus of foreclosure, encouraging lenders to reach out to delinquent borrowers. Facing political and financial pressure, lenders and servicers are struggling to develop cost- and time-effective strategies for loss mitigation.[35] However, cash-strapped lenders have fewer resources than ever to devote to loan servicing. Just as more borrowers risk losing their homes, servicers may have to lay off employees, skimp on procedural safeguards, or reduce investment in technology.

These changes do not portend well for borrowers in high-cost loans. Research has shown that the quality of loan servicing can affect the incidence and degree of loan default.[36] Poor mortgage servicing can increase loss severities and deprive families and even investors of sensible loan modification opportunities. Mortgage servicing is a crucial piece of sustainable homeownership policy that should be evaluated for policy reform as part of the response to the rising foreclosure rate.

**B. Mortgage Servicing in Bankruptcy Cases**

Most consumers who file Chapter 13 bankruptcy cases are homeowners who are in default on their mortgage at the time of their bankruptcy filing.[37] The pre-bankruptcy default usually means that the mortgage accounts of bankruptcy debtors reflect servicer activity, such as

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[32] Marc S. Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (And Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 14 (1983) ("Even where injuries are perceived, a common response is resignation, that is, "lumping it.").

[33] Fairbanks Capital Corporation settlement documents, http://www.consumerlaw.org/initiatives/mortgage_servicing/index.shtml. Fairbanks is now named Selected Portfolio Servicing.

[34] Posting of Tara Twomey, Subprime Servicing Getting Worse, to *Credit Slips* blog, http://www.creditslips.org/creditslips/2007/03/subprime_servic.html (Mar. 19, 2007).

[35] Ruth Simon, *Digging Out of Delinquency*, WALL ST. J. April 11, 2007, at D1 ("The sharp rise in delinquencies in recent months is straining mortgage companies' ability to respond quickly to borrowers, with such solutions as new repayment plans or modifications to loan agreements."); Carrick Mollenkamp, *Faulty Assumptions*, WALL ST. J. Feb. 8, 2007 (describing HSBC's expanded loss mitigation efforts).

[36] Anthony Pennington-Cross & Giang Ho, *Loan Servicer Heterogeneity &The Termination of Subprime Mortgages*, Federal Reserve Bank of St. Louis Working Paper No. 2006-024A (April 2006), *at* http://research.stlouisfed.org/wp/2006/2006-024.pdf (finding that presence of individual servicer affected chance of default to substantial and meaningful degree among large sample of subprime mortgages).

[37] TERESA SULLIVAN, ELIZABETH WARREN, JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT, 202 (2000) (half of all bankruptcy debtors are homeowners); Bahchieva, Wachter & Warren, *supra* note ___, at 104–05 (explaining that homeowners disproportionately choose Chapter 13 because Chapter 7 does not protect home equity).

imposing penalty fees (such as late charges), sending default letters, or implementing other loss mitigation strategies, that add to the amount that a debtor must pay to cure the default. The requirements of the Bankruptcy Code increase the complexity of the default situation. A bankruptcy filing imposes new burdens on mortgage servicers, including compliance with the automatic stay and with the rules regarding proofs of claim.

When a borrower in default files bankruptcy, the creditor is barred by the automatic stay from pursuing other legal action to collect the debt.[38] Pending foreclosures may not proceed against the debtor's home, unless the court grants the creditor relief from the stay to continue that action.[39] The proof of claim process that is incorporated into every bankruptcy serves as an alternative venue for adjudicating any disputes about the debt and for facilitating repayment to the creditor. In the mortgage context, the filing of a proof of claim functions in a similar manner to a complaint seeking a judgment of foreclosure. The debtor has the opportunity to "answer," by contesting the claim. Because of the expansive definition of a bankruptcy claim[40] and a bankruptcy court's equitable powers,[41] the bankruptcy process can resolve issues regarding whether the debtor actually is obligated on the debt, the amount of outstanding debt, and the nature of the obligation (for example, secured versus unsecured or contingent versus presently due).

Creditors are not required to file proofs of claim, but must do so to be eligible to receive distributions from the bankruptcy estate.[42] Barring a specific challenge based on bankruptcy law,[43] liens on the debtor's property pass unaffected through a bankruptcy.[44] Thus, a valid mortgage remains on the debtor's home, even if the mortgagee does not file a bankruptcy claim. In Chapter 13 cases, creditors usually file proofs of claim as a vehicle for establishing the amount of the outstanding arrearage, which is usually a key element in determining whether a debtor's proposed Chapter 13 plan is feasible. Additionally, a proof of claim is usually necessary if creditors wish to have the trustee collect and disburse the ongoing mortgage payments.[45] No

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[38] 11 U.S.C. § 362(a).
[39] 11 U.S.C. § 362(b).
[40] 11 U.S.C. § 101(5) ("The term 'claim' means—right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.").
[41] 11 U.S.C. § 105.
[42] 11 U.S.C. § 501(a) ("A creditor or an indenture trustee may file a proof of claim."); *see also* David Gray Carlson, *Proofs of Claim in Bankruptcy: Their Relevance to Secured Creditors*, 4 J. BANKR. L. & PRAC. 555 (1995).
[43] 11 U.S.C. §§ 544, 547 (2005).
[44] Marianne B. Culhane & Michaela M. White, *Debt After Discharge: An Empirical Study of Reaffirmation*, 73 AM. BANKR. L.J. 709, 712 (1999).
[45] *See* ELIZABETH WARREN & JAW LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 219 (5th ed. 2005) ("[T]o receive any distribution, each chapter 7 or chapter 13 creditor must submit a proof of claim."). This seemingly simple statement is complicated in Chapter 13 when a debtor may be making up past debts (arrearages) and making ongoing obligations as scheduled in the original loan. *See infra* note 130. The practices for paying mortgages during a Chapter 13 case vary across districts, yet another example of the well-documented phenomena of local legal culture in bankruptcy cases. *See* Teresa A. Sullivan, Elizabeth Warren & Jaw Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence From the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801 (1994); Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501 (1993). In many jurisdictions, mortgages are paid "outside the plan," meaning that the debtor continues to make the ongoing principal and interest payments directly to the mortgage servicer, just as before the bankruptcy. Even in these instances, however, the trustee usually collects the debtor's payment of any arrearages on the mortgage loan. Some Chapter 13 trustees require the debtor to make their regular mortgage payments to the trustee, along with the arrearage payments, because they believe that this practice reduces confusion or error and increases the chance that the debtor successfully completes the Chapter 13 plan. Whether a trustee charges a fee to

prior data seem to exist on how frequently creditors in general or mortgagees in specific actually file proofs of claim.[46] The Mortgage Study identified and examined all filed proofs of claim that corresponded to the home loans that debtors reported on their bankruptcy court schedules.[47] Proofs of claim are the most common way in which mortgage servicers interact with the bankruptcy system and may be the best mechanism for examining the overall reliability of mortgage servicing within the bankruptcy context.

A prominent Chapter 13 trustee has concluded that mortgage servicing in bankruptcy is in a "sorry state."[48] Anecdotes reinforce the aptness of this description. In one egregious case, a mortgage company filed a proof of claim for more than $1 million when the principal balance on the note was $60,000.[49] The inaccuracy stemmed from the claimants' mistake in reporting the cost of the insurance policy that the servicer forced on the debtor after the debtor's insurance lapsed.

While such a glaring error would hopefully always cause a debtor or trustee to object, more modest errors risk passing through the bankruptcy system without notice or resolution. A debtor's attorney who has developed a training program to educate attorneys about mortgage servicing issues has concluded "that the vast majority of Chapter 13 debtors and their attorneys do little or nothing about these illegal fees and charges."[50]

Mistakes or misbehavior by mortgage servicers also burden bankruptcy trustees who are responsible for ensuring accurate payments to all creditors in all cases. At a meeting of the National Association of Chapter 13 Trustees a few years ago, attendees discussed problems with mortgage servicing in Chapter 13 cases. A laundry list of grievances was aired: servicers are unable to prepare correct pre-petition claims in Chapter 13 cases; proofs of claim are filed without balances or are bloated with illegal and fraudulent fees sometimes totaling several thousand dollars; irreconcilable and unexplained balances appear on amended proofs of claim; servicers provide no contact information; and servicers refuse to provide loan payment histories.[51] Loan servicers have complained of the heightened litigation risk that they face in bankruptcy,[52] presumably because consumers have attorneys and bankruptcy courts require evidentiary hearings before granting stay relief.[53]

In early 2005, industry representatives and Chapter 13 trustees formed a "Mortgage Committee" to address how to improve the existing bankruptcy procedures that apply to

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the estate for collecting and disbursing regular mortgage payments also varies between different judicial districts and affects the proof of claim practice.

[46] *See* 1 Keith M. Lundin, Chapter 13 Bankruptcy § 67.1 (3d ed. 2000 & Supp. 2004) (stating that numerous creditors fail to file proofs of claim).

[47] *See infra* Part II.

[48] Henry E. Hildebrand III, *The Sad State of Mortgage Service Providers*, 22 AM. BANKR. INST. L. REV. 10 (2003).

[49] The proof of claim is on file with Katherine Porter. It was made in a Northern District of Texas Chapter 13 case.

[50] O. Max Gardner III, *Mortgage Securitization, Servicing, and Consumer Bankruptcy*, 2 GP Solo Law Trends & News (Sept. 2005), http://www.abanet.org/genpractice/newsletter/lawtrends/0509/business/mortgagesecuritization.html.

[51] Email communication from the Honorable Keith M. Lundin dated June 9, 2003 describing session on mortgage issues in Chapter 13 (on file with author).

[52] National Mortgage News, *Lenders Look for Way to Avoid Bankruptcy Maze* (Aug. 30, 2004) (quoting employee of servicer remarking that "[b]ankruptcy is becoming a fertile ground for a lot of loopholes and a lot of lawsuits and a lot of costs to servicers.").

[53] When judicial foreclosure is required, a state court judge should also scrutinize the lenders' pleadings. However, only about half of states require judicial foreclosure, and in many others, no deficiency is permitted against a debtor's principal residence. This latter rule reduces a court's incentive to ensure that the amount alleged to be due is correct because the foreclosure can proceed if any substantial default exists.

mortgage claims. Notably, the committee's representatives do not appear to have included any consumer debtors, other than those Chapter 13 trustees who may represent debtors as part of their private practice.[54] As of June 2007, the committee had developed a number of proposed practices. Its subcommittee on proofs of claim drafted a model proof of claim attachment. That form would supplement the identification fields that exist on the standard proof of claim.[55] The model attachment would require servicers to provide a detailed profile of the terms of the loan, including the type of the loan, its interest rate, and adjustment dates. Most importantly, it presents a format for servicers to break out the amount of any pre-petition arrearages, categorize each charge, and report how many times each type of charge had been imposed. The subcommittee does not report how close servicers' current practices are to the proposed model attachment and whether any servicers have voluntarily adopted the model form. The formation of such a committee and the obvious effort expended in developing its proposals reflect that mortgage servicers themselves recognize that their procedures in bankruptcy cases need improvement.

**C. Bankruptcy Litigation of Mortgage Claims**

Bankruptcy changes the dynamic between borrowers and servicers. The vast majority of consumers hire an attorney to represent them in their bankruptcy.[56] The consumer's retention of counsel may partially explain why most mortgage-servicing litigation occurs in bankruptcy and may suggest that attorneys or consumers are not willing to raise such claims outside of bankruptcy. As part of the bankruptcy case, the attorney may find it difficult to obtain the cooperation of the mortgage servicer and may find it necessary to litigate with the servicer to represent the debtor in the bankruptcy. Bankruptcy is the context for most servicing disputes, but the problems that bankruptcy courts have identified frequently concern servicing activity that occurred well before the bankruptcy.

In recent years, bankruptcy courts have issued opinions faulting mortgagees for providing inaccurate information and ignoring applicable laws and procedures.[57] Courts and litigants have struggled to obtain comprehensible records from servicers or lenders. A leading decision is *In re Maxwell*.[58] Tara Twomey, the co-principal investigator of the Mortgage Study, represented the debtor. The court described the discrepancies in the servicer's court filings. "Thus, Fairbanks, in February 2000, represented that the Debtor owed it $48,691.36 *less* than what it demanded of the Debtor in April of 1998 and $192,963.64 *more* than it demanded of her on July 13, 1999."[59] The court found that "Fairbanks, in a shocking display of corporate irresponsibility, repeatedly fabricated the amount of the Debtor's obligation to it out of thin air." The court noted that

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[54] As of June 2007, the National Association of Chapter 13 Trustees Mortgage Committee was comprised of Chapter 13 trustees, mortgage servicers, and their attorneys. *See*, *e.g.*, NAT'L ASS'N OF CHAPTER THIRTEEN TRUSTEES, REPORT OF MORTGAGE COMMITTEE (June 28, 2007) (manuscript on file with author).

[55] *Id.* The model "Attachment to Chapter 13 Proof of Claim" would require the creditor to provide the MERS Number for the loan, the real property tax number and parcel number, and a contact person for the servicer (not just the servicer's attorney).

[56] TERESA SULLIVAN, ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA, 22–23 (1989) (finding only 4% of debtors in a sample of 1529 cases filed *pro se* petitions).

[57] *See* Hildebrand, *supra* note 21 (describing mortgage servicers' inability or lack of effort to make their records match the debtor's plan or to comply with the requirements of the Bankruptcy Code such as disclosing fees and costs.).

[58] Maxwell v. Fairbanks Capital Corp. (In re Maxwell), 281 B.R. 101 (Bankr. D. Mass. 2002).

[59] *Id.* at 114.

criminal penalties exist for presenting a fraudulent claim. The court held that Fairbanks violated the Fair Debt Collection Practices Act, the Real Estate Settlement Procedures Act, the Massachusetts Consumer Credit Cost Disclosures Act, and that the terms of the loan were unconscionable. After the court's decision, the debtor settled the case for a full discharge of her mortgage, $50,000 in damages, and attorney's fees.

Other courts have identified a similar pattern of servicer behavior to that described in *Maxwell*. Unable to decipher a servicer's records, even after ordering further document production, one court finally resorted to creating its own amortization table. The judge stated that "[t]he poor quality of papers filed by Fleet to support its claim is a sad commentary on the record keeping of a large financial institution. Unfortunately, it is typical of record-keeping products generated by lenders and loan servicers in court proceedings."[60] In some instances, mortgagees apparently are unable to offer any documentation. In *Litton Loan Servicing v. Garvida,* the bankruptcy court ordered the servicer to provide an accounting of the loan balance after the debtor asserted that a lesser amount was due.[61] The servicer failed to do so, and the Bankruptcy Appellate Panel affirmed that an adjustment of the mortgagee's claim was an appropriate remedy.

Mortgagees' accounting has created problems in bankruptcy contexts other than proofs of claim. The nature of the errors is rarely due to the procedural posture of the case, however, so these cases may well indicate that similar problems pervade mortgage claims. In the situations below, debtors and their counsel may be forced to confront servicing inaccuracies that may go unidentified in proofs of claim because attorneys and debtors may not scrutinize the claims. Motions for relief from the stay, for example, put debtors at direct risk of losing their home, spurring debtors and their attorneys to respond to the servicers' pleadings. Several courts have complained about unsubstantiated or patently false allegations in mortgagees' motions for relief from the stay. The Bankruptcy Court for the Southern District of New York has lamented mortgage servicers' practice of filing motions to vacate the automatic stay based on poor accounting practices or non-existent records.[62] The court rejected what it termed the mortgage servicers' "dog ate my homework excuses,"[63] emphasizing the damage to the judicial process that occurs when a court is asked to rule on incorrect or baseless facts. It also noted that in each of the three separate cases at issue, the mortgage servicer's actions had created a danger that a family would lose its home without just cause and in violation of the Bankruptcy Code.

Other cases that question the reliability of servicers' accounting arise after a bankruptcy is filed at the time when a debtor is trying to complete a confirmed Chapter 13 plan. In *Jones v. Wells Fargo Home Mortgage*, the debtor filed an adversary proceeding when he was unable to obtain an accounting from Wells Fargo after he refinanced his loan during bankruptcy.[64] Upon examination of all the servicer's actions, the court identified a variety of accounting errors and impermissible behavior, including miscalculations of both prepetition and postpetition obligations and attempts to collect impermissible fees.[65] Wells Fargo also applied payments in

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[60] *In re* Wines, 239 B.R. 703, 709 (Bankr. D.N.J. 1999).
[61] *In re* Garvida, 347 B.R. 697 (9th Cir. BAP 2006).
[62] *In re* Gorshtein, 285 B.R. 118 (Bankr. S.D.N.Y. 2002).
[63] *Id.* at 126.
[64] *In re* Jones, No. 03-16518, 2007 WL 1112047 (Bankr. E.D. La. 2007).
[65] Perhaps most egregiously, Wells Fargo charged the debtor for sixteen property inspections during the pendency of the bankruptcy case but its representative "could not list a single reason why an inspection would have been ordered postpetition, nor could she detail any reason why continuous monitoring of the property was necessary or reasonable." *Id.* at *11.

violation of the plan—a practice that increased the interest charged above what was actually due.[66] The court noted that Wells Fargo's actions resulted in "such a tangled mess that neither Debtor, who is a certified public accountant, nor Wells Fargo's own representative could fully understand or explain the accounting offered."[67] The court imposed a sanctions award of $67,202.45 and ordered Wells Fargo to implement an accurate accounting system for post-petition mortgage payments in all cases in its district.[68] Another court reduced a mortgagee's claim under the equitable theory of recoupment after finding that the servicer violated the Real Estate Settlement Procedures Act in failing to respond to the debtor's requests for clarification of the account balance. The opinion's first sentence reveals the court's frustration: "Is it too much to ask a consumer mortgage lender to provide the debtor with a clear and unambiguous statement of the debtor's default prior to foreclosing on the debtor's house?"[69]

Some courts have targeted the law firms retained by mortgagees or servicers. Judge Steen found that a large creditor's firm had filed an erroneous and unsubstantiated objection to plan confirmation on behalf of its client, Countrywide Home Loans.[70] Judge Morris Stern fined a New Jersey law firm for filing 250 court pleadings in which the signature page had been pre-signed before review by the servicer.[71] His opinion sternly reminds servicers and attorneys that technological "advances" do not absolve the responsible humans of their duty to the court.[72] Another court has observed "instances in which attorneys representing alleged mortgagees or their servicing agents did not know whether the client was a mortgagee or a servicing agent, or how their client came to acquire its role."[73]

Bankruptcy courts have occasionally been the venue for class-action lawsuits based on mortgage servicing abuses. Purported wrongdoing by mortgage lenders sparked two cases in the Southern District of Alabama. One class-action case alleged that a lender had failed to file fee applications to recover attorneys' fees included in proofs of claim, and later the lender simply stopped disclosing the fees but continued charging them to debtors' accounts. The court ordered that the lender return the disputed fees to all class members.[74] A separate class-action suit complained about the lenders' practice of charging a "proof of claim fee" or "bankruptcy fee." The court approved a settlement that required the lenders to credit each class member's loan account in the amount of the fees.[75] In Nevada, a proposed class-action suit was filed to challenge Ocwen Federal Bank's practice of including a "proof of claim fee" in claims filed in

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[66] *Id.* at *3.
[67] *Id.* at *4.
[68] *Michael L. Jones v. Wells Fargo Home Mortgage* (*In re Jones)*, Case. No. 03-16518; Adv. No. 06-01093. Supplemental Memorandum Opinion (Aug. 29, 2007). The court believed that "it would be more productive and effective to accept Well Fargo's offer to modify its practices" than to impose a "large monetary fine." Slip op. at 13.
[69] *In re* Thompson*,* 350 B.R. 842, 844–45 (Bankr. E.D. Wis. 2006).
[70] *In re* Allen, Memorandum Opinion regarding Sanction of Creditor's Attorneys, Case No. 06-60121 (Jan. 9, 2007), http://www.nacba.org/files/email/Hamm-Memorandum_Opinion_re_Sanctions_v_Barrett_Burke.pdf; *see* Order Sanctioning Barrett, Burke, Wilson, Castle, Daffin & Frappier, *In re* Allen, No. 06-60121 (Bankr. S.D. Tex. June 18, 2007) (fining the law firm $75,000).
[71] *In re* Jenny Rivera, 342 B.R. 435 (Bankr. D.N.J. 2006).
[72] *Id.* at 467. *See also* Allen, *supra* note 38 (describing the close relationship between servicers and their "outside" counsel, who receive some pleadings "set up" with data from the servicer's computer system.).
[73] *In re* Schwartz, No. 06-42476JBR, 2007 WL 1188348, (Bankr. D. Mass. April 19, 2007). In that case, the "creditor" claimed to have foreclosed before the bankruptcy filing but was ultimately unable to show that it had the right to undertake any foreclosure activity.
[74] *In Re* Slick, No. 98-14378-MAM, Adv. No. 99-1136 (Bankr. S.D. Ala. Nov. 22, 2002).
[75] *In Re* Harris, No. 96-14029-MAM, 00-11321-MAM, Adv. No. 99-1144 (Bankr. S.D. Ala. Jan. 13, 2005).

Chapter 13 cases.[76] This case was transferred by the Judicial Panel on Multidistrict Litigation to the Northern District of Illinois and apparently remains pending.[77] Servicers have not changed their practices based on these isolated cases, despite the breadth of relief granted or requested for each class.

In general, disputes about mortgage servicing have been two-party contests between debtors and mortgage servicers. Just this year, that situation changed. The U.S. Trustee Program participated in litigation over an order to a leading mortgage servicer (Countrywide) and its prominent creditor's counsel (Barrett Burke) to show cause why they should not be sanctioned for filing a motion for relief from the stay that was allegedly inaccurate.[78] On its own volition, the Office of the United States Trustee submitted a statement in response to the show cause order.[79] The U.S. Trustee suggested that it conduct further examination and discovery pursuant to Federal Rule of Bankruptcy Procedure 2004 to determine whether Barrett Burke and Countrywide were aware of ongoing problems with the accuracy of their pleadings and what those parties were doing to address these problems.[80] At that point, Barrett Burke retained outside counsel to represent it, who filed a motion to strike or limit the U.S. Trustee's motion for discovery,[81] but the court denied the motion.[82] The court later affirmed that the U.S. Trustee had standing to appear and be heard on matters raised in show cause orders and had the authority to conduct discovery under Bankruptcy Rule 2004.[83] A final order has not yet been issued on the show-cause hearing. The issues of the propriety and amount of sanctions remain pending. Undeniably, however, the participation of the U.S. Trustee changed the character of the litigation and exposed servicers and their attorneys to having their mortgage accounting and pleading

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[76] *In re* Dunlap, No. 03-14317-LBR, Adv. No. 03-1429, (Bankr. Nev. Jan. 26, 2005); Nevada judge green-lights class action against mortgage provider, CONSUMER BANKRUPTCY NEWS, Feb. 17, 2005 at 2. T.

[77] *In re* Ocwen Federal Bank FSB Mortgage Servicing Litigation, 04-cv-2714, MDL-1604, N.D. Ill.

[78] Order Requiring Countrywide Home Loans, Inc. to Appear and Show Cause Why It Should Not Be Sanctioned for Filing a Motion for Relief From Stay Containing Inaccurate Debt Figures and Inaccurate Allegations Concerning Payments Received From the Debtor, *In re* Parsley, No. 05-90374 (Bankr. S.D. Tex. Feb. 12, 2007).

[79] Statement of the United States Trustee Regarding This Court's Order Requiring Countrywide Home Loans, Inc., [and, Barrett Burke Wilson Castle Daffin & Frappier, L.L.P. Attorneys and Personnel] to Appear and Show Cause Why [They] Should Not Be Sanctioned for Filing a Motion for Relief From Stay Containing Inaccurate Debt Figures and Inaccurate Allegations Concerning Payments Received From the Debtor, *In re* Parsley, No 05-90374, (Bankr. S.D. Tex. Mar. 3, 2007). In addition to briefing the relevant legal issues and asking the court to permit it to conduct additional discovery, the U.S. Trustee set forth evidence of prior litigation asserting that Barrett Burke had been accused of filing inaccurate pleadings. These cited cases included *In re* Allen, 2007 WL 115182 at 5–6 (Bankr. S.D. Tex.) and *In re* Thompson*,* 01-10399-RLJ-13 (Bankr. N.D. Tex. 2003) (imposing sanction against Barrett Burke and its client CitiFinancial Mortgage).

[80] Fed. R. Bank. Proc. 2004(b) (establishing an expansive examination into "the acts, conduct, or property or to the liabilities and financial condition of the debtor").

[81] Motion of Barrett Burke Wilson Castle Daffin & Frappier, L.L.P. to Strike or, In the Alternative, Limit Issues and/or Continue Show Cause Hearing (Docket #29), *In re* Parsley, No. 05-90374 (Bankr. S.D. Tex. Mar. 5, 2007).

[82] Order Granting in Part and Denying in Part Motion of Barrett Burke Wilson Castle Daffin & Frappier, L.L.P. to Strike or, In the Alternative, Limit Issues and/or Continue Show Cause Hearing, *In re* Parsley, No. 05-90374 (Bankr. S.D. Tex. Mar. 6, 2007).

[83] Findings of Fact and Conclusions of Law Regarding Barrett Burke, Countrywide Home Loan, Inc., and McCalla Raymer, LLC's Emergency Motions for Protective Order, *In re* Parsley, No. 05-90374 (June 6, 2007) (citing 11 U.S.C. § 307 as the basis for the U.S. Trustee's standing and stating that Countrywide and Barrett Burke "must comply with the production requests of the U.S. Trustee."). Indeed, another judge in the same judicial district (Southern District of Texas) specifically requested that the U.S. Trustee participate in litigation before that court about the accuracy of Barrett Barke's mortgage claim-related pleadings. Request for Participation by US Trustee, *In re* Allen, No. 06-60121 (Bankr. S.D. Tex. Mar. 9, 2007).

practices in Chapter 13 cases scrutinized on a more systematic basis than in prior single-case litigation.

Mistakes or misconduct by mortgage companies jeopardize the ability of courts and trustees to administer bankruptcy cases correctly and fairly. Other creditors are harmed if mortgage companies wrongly divert money that should be available to pay unsecured creditors. Such overpayment harms debtors because it increases their burden in confirming and completing repayment plans. As one bankruptcy court recognized, mistakes by creditors, who are in control of the accounts, impose additional costs to sort out such problems on debtors, the party that can least afford such expense.[84]

## II. METHODOLOGY

The Mortgage Study is a large, multi-state study of the home loans of Chapter 13 debtors. Tara Twomey and I are the principal investigators in the Mortgage Study.[85] The National Conference of Bankruptcy Judge's Endowment for Education, a non-profit and non-partisan organization that funds basic research and education about bankruptcy, provided financial support for the Mortgage Study.[86] The Endowment for Education is not responsible for the data or findings, which are solely my responsibility. No other entity or organization provided funding or participated in the research.

The Mortgage Study's principal objective was to create a new, original database that would improve researchers' ability to examine the intersection of mortgage lending and bankruptcy. The final sample contains 1733 Chapter 13 bankruptcy cases filed by homeowners. The sample was constructed using the case report feature on PACER and includes cases from forty-four judicial districts in twenty-four states.[87] The sample was constructed by selecting every fifth case filed between April 1, 2006, and April 30, 2006, in which the debtor reported owning a home, regardless of whether any liens encumbered their homes.[88] If a case was converted from another chapter or the debtor did not own a home, that case was excluded and the next case that met the selection criteria was included in the sample. Thus, the sample roughly reflects the proportional size of Chapter 13 filings among all judicial districts in the sample.[89]

The sample is not representative of all homeowners in bankruptcy for two reasons. First, the sample includes only Chapter 13 bankruptcy cases and excludes Chapter 7 cases. Prior

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[84] *Williams v. Fairbanks Capital Corp. (In re Williams)*, 2001 WL 1804312, *2 (Bankr. D.S.C. 2001) (awarding punitive damages to debtor as a result of actions and misrepresentations of creditor).

[85] When the study began, Tara Twomey was a clinical instructor at Harvard Law School. She is currently a Lecturer in Law at Stanford Law School and a consultant for the National Association of Consumer Bankruptcy Attorneys and the National Consumer Law Center. Neither organization had any involvement in this research. They provided no funding and have no access to the data.

[86] More information about the National Conference of Bankruptcy Judges' Endowment for Education is available on its website: http://www.ncbj.org/education.php3 (last visited Sept. 7, 2007).

[87] We thank the Chief Judges of each district in the Mortgage Study (with the sole exception noted below) for granting a waiver of PACER fees for this research. The Southern District of Texas denied the application for a fee waiver, stating that it had a blanket policy against such waivers, notwithstanding the written policy of the Judicial Conference of the United States that individual researchers associated with educational institutions are eligible for waivers if they can show cause. *See* Electronic Public Access Fee Schedules (Sept. 9, 2006), http://pacer.psc.uscourts.gov/documents/epa_feesched.pdf.

[88] To be included in the sample, a debtor must have been a homeowner. Ninety-six percent of homeowners had outstanding mortgage debt when they filed bankruptcy.

[89] For example, in a district with few Chapter 13 filings, such as Wyoming, only two cases are in the sample. At other extreme, the sample contains 164 cases from the Northern District of Georgia because that district has a large number of Chapter 13 cases filed.

studies have confirmed that the percentage of homeowners in Chapter 13 bankruptcy is much higher than in Chapter 7 bankruptcy.[90] Sampling only Chapter 13 cases made it easier to construct a sample of homeowners in bankruptcy because it eliminated the need to examine thousands of Chapter 7 cases to find those filed by homeowners. The exclusive focus on Chapter 13 also enhances the usefulness of the Mortgage Study's data to examine bankruptcy as a home-saving device.[91] Chapter 13 is particularly attractive to homeowners who are in default on their mortgage loans because it permits them to retain their home and cure arrearages over time through their repayment plans.[92] The rules and procedures that govern the proof-of-claim process apply equally in Chapter 7 and Chapter 13 cases. Mortgagee claims are much less important in Chapter 7 because Chapter 7 does not provide a remedy to debtors who are in default on their home loans.

The other limitation of the sample was the choice of where to sample. By design, the sample only contains bankruptcy cases filed in districts where the applicable state law permits non-judicial foreclosures of debtors' principal residences.[93] Non-judicial foreclosure is faster and less expensive than judicial foreclosure.[94]

The more favorable remedies of non-judicial foreclosure reduce the willingness of mortgage lenders in states with such laws to negotiate upon default and increase the debtors' need to file bankruptcy to create a forum to contest the foreclosure and restructure the home loan. Limiting the sample to states that permit non-judicial foreclosure increased the proportion of homeowners in default on mortgage loans in the sample. The forty-four judicial districts in the sample capture variations in local bankruptcy practice and ensure that all of the nation's largest mortgage lenders and servicers are represented. The bankruptcy claims process should not differ between judicial and non-judicial foreclosure states, but instead may vary by local rule imposed in a given judicial district.

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[90] Consumer Bankruptcy Project III (CBP) data indicate that homeownership is much more prevalent among Chapter 13 debtors than Chapter 7 debtors. In the CBP's core sample of 1250 cases filed in 2001 in five judicial districts, 30% of Chapter 7 cases were filed by homeowners. In contrast, 75% of Chapter 13 debtors owned their homes when they filed bankruptcy (data on file with author).

[91] Scarce data exist on how homeowners fare in bankruptcy. *See* Melissa B. Jacoby, *Bankruptcy Reform and Homeownership Risk*, 1 ILL. L. REV. 323, 352 (2007) ("Although scholars of mortgage debt and foreclosure generally may be aware that some homeowners with housing problems file for bankruptcy, [c]hapter 13's specific mortgagor protection feature has not received sufficient discrete and sustained scholarly attention."). The most extensive study to date was conducted based on cases filed in 2001 and did not rely on proofs of claim or home loan documents. *See* Raisa Bahchieva, Susan Wachter, and Elizabeth Warren, *Mortgage Debt, Bankruptcy, and the Sustainability of Homeownership*, in CREDIT MARKETS FOR THE POOR 74 (Patrick Bolton & Howard Rosenthal, eds. 2005).

[92] *See* 11 U.S.C. §§ 1322(b)(3) and (5), 1325(a)(5) and 362(a).

[93] The following twenty-four states permit non-judicial foreclosure of residential mortgages: Alabama, Arkansas, California, Colorado, District of Columbia, Georgia, Idaho, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Mississippi, Montana, New Hampshire, North Carolina, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, West Virginia, and Wyoming. There are forty-four judicial districts in these states, so our sample represents 49% of the judicial districts in the United States.

[94] *See* GRANT NELSON & DALE WHITMAN, REAL ESTATE FINANCE LAW 635 (2002); BARLOW BURKE, REAL ESTATE TRANSACTIONS 336 (2006) ("[Power of sale foreclosure] is cheaper than judicial foreclosure and takes less time."). Judicial foreclosure procedures vary depending on state law. Typically these steps include: 1) summons, complaint, answer, motion for summary judgment and a trial; 2) appointment of a referee to compute the debt and to search the title; 3) referee report; 4) court order authorizing the sale; 5) sale advertisement; 6) sale; and 7) judgment confirming the sale. *Id.* at 334. Non-judicial foreclosure typically proceeds under a deed of trust that permits a third-party trustee, upon default, to sell the property in a private sale. Although some public notice is required by all states, a non-judicial foreclosure, as its name suggests, does not require court supervision or the filing of a lawsuit. *Id.* at 337.

All data were drawn from the public court records filed in each case.[95] The debtor files schedules that provide detailed information on debts, assets, and income at the time of the bankruptcy. These schedules are filed under penalty of perjury,[96] and may provide more complete and reliable evidence of debtors' financial situations than survey or interview methods.[97] Other leading studies of consumer bankruptcy typically rely on debtors' schedules as their primary source of information about debtors' financial situations.[98] From the schedules, we coded debtors' incomes, current home-related expenses, their valuations of their homes, any relevant exemptions claimed in real property, and any other information the debtor provided about loans that encumbered their home, including total debt, arrearages, and monthly payments.[99]

The major methodological innovation of the Mortgage Study was to use mortgagees' proofs of claim and supporting documentation to collect more detailed information on home loans than was available from the schedules.[100] We drew data primarily from four documents: the proof of claim itself and, when attached to the proofs of claim: any itemization or detail of the amount claimed; a copy of the security interest that pertained to the loan; and a copy of the note that evidenced the obligation. Relying on these documents, we coded the type and terms of each loan; the amount and nature of any arrearages; the names of the mortgagee, originating lender, and servicer; and the outstanding obligation at origination and at the time of the bankruptcy. We also coded any objections to mortgagees' proofs of claim[101] and any amended claims. If a case had only one mortgage loan, we coded 152 data points for that case; when

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[95] Most documents were obtained from PACER, but paper records were consulted if necessary. When documents were initially missing, we rechecked the PACER docket ten months after the initial collection to see if the documents had been added. We thank Edward Boltz of the Law Offices of John T. Orcutt and Reid Wilcox, Clerk of the Bankruptcy Court for the Middle District of North Carolina, for their help in obtaining paper court records. We were shocked to learn that in the Eastern and Middle Districts of North Carolina, the debtor's attorney is not sent a copy of the proofs of claim and that they are not made available on PACER for easy review.

[96] Teresa Sullivan, Elizabeth Warren, & Jay Lawrence Westbrook, *Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings*, 59 STAN. L. REV. 213, 218 (2006).

[97] RONALD J. MANN, CHARGING AHEAD 61 (2006) (noting problems with Federal Reserve's Survey of Consumer Finance data); David B. Gross & Nicholas S. Souleles, *Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence From Credit Card Data*, 117 Q. J. ECON. 149, 151, n. 2 (2001) ("SCF households substantially underreport their bankcard debt."). To date, the Mortgage Study has not surveyed or interviewed debtors. Demographic information about homeowners is available from the Consumer Bankruptcy Project III (2001) and the ongoing Consumer Bankruptcy Project IV (2007), which use surveys and interviews.

[98] *See* Sullivan, Warren & Westbrook, *Less* Stigma, *supra* note ___, at 213; Scott Norberg & Andrew J. Velkey, *Debtor Discharge and Creditor Repayment in Chapter* 13, 39 CREIGHTON L. REV. 473 (2006); Marianne B. Culhane & Michaela M. White, *Debt After Discharge: An Empirical Study of Reaffirmation*, 73 AM. BANKR. L.J. 709, 712 (1999).

[99] We drew this information from the following documents in each case: docket, petition, Schedules A, C, D, I, and J, Form B22, and the Chapter 13 plan. These documents were available and complete in well over 99% of all cases in our sample; there are very few missing observations. We coded only the original version of the schedules, including any separately and later filed schedules that were not included in the debtors' original pleadings. We did not code information from the amended schedules because we were interested in the debtors' initial ability to gauge the amount owing on their mortgage debts.

[100] Real property that was not the debtor's principal residence was ignored, as were any corresponding proofs of claim for such properties. No debtor was permitted to have more than one principal residence.

[101] The initial coding revealed very few objections to proofs of claim. To ensure that these data were reliable, we checked both the docket and the claims register of each case a second time. We include as data any objections identified upon either the first or the second review.

debtors had more loans, there were more data points to capture.[102] With its combination of data from creditors' pleadings and debtors' pleadings, the Mortgage Study database offers a rich and detailed picture of the home loans of families in bankruptcy.[103]

Data were coded into a specially designed database. We used only three coders, which reduced concerns about intercoder consistency. Two coders had law degrees, and the third coder has prior experience in coding bankruptcy data for academic research. All coders received individual training on practice cases to reduce errors and improve the reliability of data coding. Coders referred to a written codebook during the coding process and noted any unusual situations. We reviewed the coding in each of the cases that coders flagged as unusual to ensure that these cases were coded correctly.

To improve the reliability of the data, we deployed two standard procedures. First, we ran error traps to verify the quality of data entry and improve the accuracy of the database. Two examples illustrate the types of checks that we used: we reviewed any proof of claim dates that were entered as being before April 2006, when the cases were filed; and we checked for any dollar figure entries that began with a decimal point or exceeded one million dollars. When we identified errors, we corrected the database. Second, a random sample of 10% of the cases (approximately 175 cases) was recoded blind—without reference to the prior coding and without knowledge that an initial coding existed. We compared each variable of each case between the initial coder and the recoder, noted any discrepancies, and checked for mistakes in the initial coding. The data were 99% accurate, and no systematic errors were identified between coders.[104]

The final data were transferred to Microsoft Excel and SPSS for Windows for analysis. All dollar figures are presented as found in court records without adjustment for inflation.

## III. FINDINGS

The Mortgage Study data permit multiple analyses of the reliability of mortgage claims. The overall pattern of findings is disturbing. Many creditors do not comply with the rules of the bankruptcy system, and a significant fraction of claims appear to request impermissible, unreasonable or inaccurate charges. Yet, the vast majority of all claims pass undisturbed through the bankruptcy system, potentially skewing distributions to all creditors and weakening the integrity of the Chapter 13 process.

### A. Required Documentation for Mortgage Claims

Creditors who want to receive bankruptcy distributions must file a proof of claim using the official form or something that substantially conforms to the form.[105] A proof of claim should either consist of a completed Official Form 10 or a similar document. Form 10 directs creditors to attach an itemized statement if their claim "includes interest or other charges" in addition to the principal amount.[106] This requirement would apply to all typical mortgage claims, as nearly all of these obligations bear interest. The itemization permits the collective parties in a

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[102] The exact number of data points actually coded (as opposed to left blank because they did not apply) varied with the case based on several factors, including the number of home loans, the type of loan, and the quantity of documentation attached to the proof of claim.

[103] In total, approximately 200 data points were coded for each case, making the Mortgage Study useful for studying other hypotheses about bankruptcy and homeownership.

[104] The error rate was 1.04%. To calculate the error rate, we compared the original coding and the recoding and determined the number of errors in the initial coding, and divided this number by the number of data points.

[105] Fed. R. Bankr. P. 3001(a).

[106] Official Form 10, *available at* http://www.uscourts.gov/bankform/formb10new.pdf.

bankruptcy—debtor, trustee, other creditors—to ensure that the total amount claimed consists of sums that are permitted under the terms of the note and mortgage.

Federal Rule of Bankruptcy Procedure 3001 imposes two additional evidentiary requirements on proofs of claim:[107] a copy of the writing if one evidences the claim;[108] and evidence of perfection if the creditor asserts a security interest in the property of the debtor. [109] These rules permit debtors, trustees, and courts to evaluate the accuracy of claims and ensure that all payments are made in accord with the Bankruptcy Code and applicable nonbankruptcy law. Without documentation, parties cannot ensure that the creditors' claims correctly reflect the terms of the loan and all payments made, and comply with applicable law.

In the Chapter 13 cases in the sample, mortgage creditors filed proofs of claim to correspond with 81.7% of the home loans that debtors listed on their bankruptcy schedules.[110] The documentation requirements for these mortgage proofs of claim are unambiguous and long-standing. Nevertheless, these laws were not consistently respected. A substantial fraction of claims lacked one or more required attachments. Figure 1 illustrates the findings for all proofs of claim in the sample that relate to a loan secured by a debtor's home.[111]

A majority of claims (83.9% of all proofs of claim in the sample) had the itemization attached to them.[112] Despite the instruction on Form 10, the remaining fraction (16.1%) did not have an itemization attached. In the sample, about one in six claims was not supported by an itemization. Part B, *infra*, discusses the quality of these itemizations.

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[107] It is possible that a single document could perform the function of both the note and the mortgage in creating the parties' rights and obligations in the transaction. We did not identify any instances in which the note was incorporated into the mortgage. For consumer home loans, nearly all of which are intended for resale on the secondary market as part of mortgage-backed securities, separation of the note and the mortgage helps ensure that the note is a negotiable instrument under law that will be subject to the holder-in-due-course defense upon sale.

[108] Fed. R. Bankr. P. 3001(c) ("When a claim, or an interest in property of the debtor securing the claim, is based on a writing, the original or a duplicate shall be filed with the proof of claim.").

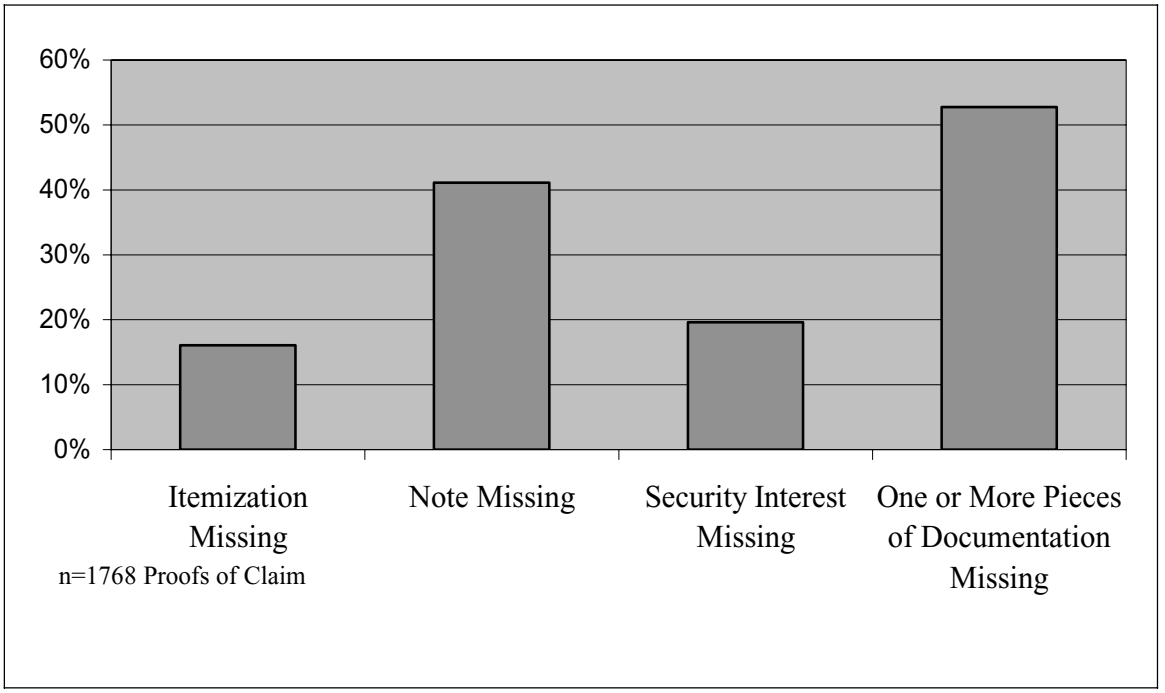
[109] Fed. R. Bankr. P. 3001(d) ("If a security interest in property of the debtor is claimed, the proof of claim shall be accompanied by evidence that the security interest has been perfected.").

[110] A proof of claim was filed to correspond with over 90% of the home loans listed on the debtors' schedules. To boost the completeness of the Mortgage Study database, in each case in which a proof of claim was not initially located to correspond with a home loan, a second check was conducted approximately eighteen months after the case was filed to ensure that all available proofs of claim were incorporated into the database.

[111] These data come from only the original proofs of claim, and do not reflect any attachments that may have been added by mortgagees when they filed amended proofs of claim. However, note that the number of amended claims was relatively small. Only 9.7% of all claims had an amended claim associated with them.

[112] N= 1768 proofs of claim. Itemizations were attached to 1484 of these proofs of claim.

*Figure 1: Percent of Proofs of Claim Missing Required Documentation*




The most fundamental piece of evidence to support a claim is a copy of the promissory note or instrument establishing the existence and terms of the debt. Yet, four of ten claims were missing this crucial evidence. A note was not attached to 41.1% of claims. Only 58.9% of proofs of claim filed by mortgagees had a writing attached to evidence the debt.

Given the importance of a note to establish the principal amount of debt, the interest rate, and other key terms, it was surprising that the note was more frequently missing from claims than a copy of the security interest. The higher likelihood that a claim will not have a note attached is troubling for several reasons. First, the note is not easily available from another source. Unlike the security interest, notes are not recorded in the public records. If the debtor has lost the note, and the servicer does not provide one, the servicer has an informational advantage, which the rule was presumably designed to eliminate. Second, Rule 3001(c)'s requirement that a copy of a writing be attached applies widely. Nearly all debts are evidenced by writing in today's commercial economy. Yet, even when the claim is for a large debt such as a mortgage, creditors do not produce instruments or contracts in compliance with the proofs of claim rules. The lack of notes in the Mortgage Study hints that this aspect of Rule 3001 compliance may be even worse for smaller claims evidenced by a writing, such as credit-card debts.[113] Third, the promissory note or other debt instrument is absolutely necessary to enable the debtor, trustee, and other creditors to verify that the amount asserted to be owed on the proof of claim is correct. The note contains the initial account balance, the applicable interest rate, and the terms that govern the mortgagee's ability to charge fees upon default.[114]

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[113] John Rao, *Debt Buyers Rewriting of Rule 3001: Taking the "Proof" Out of the Claims Process*, 23-AUG AM. BANKR. INST. L. REV. 16 (July/Aug. 2004).

[114] A few states have specific laws that govern foreclosure costs and fees. *See, e.g.*, Mich. Comp. Laws Ann. 600.2431 (West 2000) (capping attorneys' fees in a non-judicial foreclosure at no more than $75 if the mortgage does not specifically contract for such attorneys' fees). In most instances, the note contains broad language on

Creditors were more diligent about attaching documentation to show they hold a valid security interest in the debtor's home. A perfected security interest such as a copy of a recorded mortgage or deed of trust accompanied 80.4% of mortgagees' proofs of claim. As shown in Figure 1, 19.6% of claims were not supported by a security interest to document the creditor's lien in the debtor's home. In light of the prior finding on promissory notes, it is tempting to view Rule 3001(d)'s requirement of attaching a security interest as a relative success that may not merit policy attention. However, the fact remains that one in five creditors ignores required federal law when they participate in a bankruptcy case. With much less evidence of clear misbehavior by debtors,[115] Congress imposed audits on debtors' schedules to ensure full disclosure of assets and permitted dismissal of debtors' cases for failure to provide required documentation in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.[116] These actions evidence Congress' belief that bankruptcy is a serious and important process and that compliance with the technical process is necessary to preserve the system's integrity. To be sure, there could be reasons to have different standards for debtors and creditors. In the vast majority of instances, debtors are the party seeking bankruptcy relief. Thus, it may be fair to impose an increased burden on debtors as the "moving" party in bankruptcy cases. Nonetheless, creditors who choose to participate in bankruptcy cases also submit themselves to federal process. Viewed from this perspective, the nearly twenty percent (19.6%) of proofs of claim without security interests represents a structural weakness in the integrity of bankruptcy procedures. Creditors should be required to comport with the rules that govern their responsibilities to debtors, courts, and other creditors.

Creditors' compliance with the rule requiring the attachment of evidence of a valid security interest likely results from the practice of a few Chapter 13 trustees of objecting to claims if the security interest is missing. Further, security interests are publicly available from local land records if the obligation was properly recorded. Thus, while loan documentation may get lost in the shuffle between lenders and servicers or between servicers if the obligation is transferred, this problem can be remedied by relying on public records. In contrast, the parties cannot rely on a neutral third-party to maintain a readily accessible copy of the promissory note.

These factors may combine to make mortgagees fear that failure to attach a security interest is a red flag that the obligation was not, in fact, properly perfected, and is subject to

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charges and costs. For example, the Fannie Mae uniform instruments gives the note holder a "right to be paid back by [the borrower] for all of its costs and expenses in enforcing this Note to the extent not prohibited by applicable law. Those expenses include, for example, reasonable attorneys' fees." *See* Fannie Mae, Multistate Fixed Rate Note—Single Family, 6e, https://www.efanniemae.com/sf/formsdocs/documents/notes/pdf/3200.pdf. Particularly in the subprime market or for refinance loans, a uniform instrument might not be used. However, even the Fannie Mae language permits borrowers to raise defenses in some situations. For example, it puts a "reasonableness" limitation on attorneys' fees. Also, the language on "costs and expenses" is modified by "enforcing this Note." Costs that are not necessary to enforce the Note—for example, fax fees, arguably cannot be justified by this provision.

[115] *See* Steven W. Rhodes, *A Preview of "Demonstrating a Serious Problem with Undisclosed Assets in Chapter 7 Cases*" 2002 5 NORTON BANKR. L. ADVISER 1 (May 2002) (finding in a one district sample that 41% of asset cases (a small fraction of all Chapter 7 cases generally) contained inaccuracies in debtors' list of assets and valuations); Recommendations for Reform of Consumer Bankruptcy Law by Four Dissenting Commissioners, REPORT OF THE NAT'L BANKRUPTCY REVIEW COMMISSION, ch. 5 at 14 n. ("The Commission repeatedly heard testimony that the information reported in the debtors' schedules is unreliable.").

[116] BAPCPA, Pub. L. No. 109-8, § 603, 119 Stat. 23, 122 (authorizing random audits of debtors); Pub. L. No. 109-8, §316, 119 Stat. 23, 92 (to be codified at 11 U.S.C. § 521(i)) (automatically dismissing a debtor's bankruptcy case if required information, including payment advices, are not filed).

avoidance under the Bankruptcy Code.[117] In the context of a mortgage, avoidance typically relegates the obligation to unsecured status in bankruptcy and dramatically reduces the debtor's obligation to pay the full amount of the debt.[118] Such a mistake also redounds to the benefit of unsecured creditors, whose distributions are higher if the mortgage can be paid pro rata with other unsecured claims. While most mortgages probably are recorded correctly in the public records, a few enterprising trustees may discover other errors in the mortgage process such as inadequate witnesses to the obligation that subject the claim to avoidance. Attaching evidence that the creditor has a valid security interest may defer any further scrutiny of the mortgage and weaken the likelihood that these problems are identified. Most trustees simply do not look beyond whether a security interest is attached, and indeed, the data suggest that in at least a modest fraction of instances, the trustees do not even care if the security interest is missing entirely.

The security interest, however, is also useful for reasons beyond validating the perfection of the lien. The deed of trust or mortgage typically has provisions that bear on the propriety of the servicer's accounting. For example, most model Fannie Mae instruments require the lender to either apply or refund partial payments within a "reasonable period of time."[119] Based on this language, a debtor could challenge a servicer's practice of holding amounts in suspense accounts for several consecutive months. When a claim is not supported by the required documentation, debtors, trustees, and other parties in interest cannot readily validate the claim against the terms of the obligation.

Compliance with the documentation requirements varied among claims filed in different judicial districts. In some districts, there are very few observed cases because Chapter 13 filings are infrequent. Because there were only a few claims in the sample from judicial districts with few bankruptcy filings, the percentage of claims with documentation attached could change dramatically with the addition of a single case in these jurisdictions. Thus, these data are best used to observe a general pattern of variation, rather than as robust measures of compliance in any individual district.

As shown by the top and bottom of the lines in Figure 2, there was at least one district in which no claims had a required type of documentation and at least one district in which all claims had a type of documentation. The boxes in Figure 2 represent the districts whose compliance was in the middle two quartiles of the variation. The bottom of each box shows the rate of compliance in the district that was at the first quartile (25% of districts had worse compliance). The top of each box shows the rate of compliance in the district that was at the top quartile (75% of districts had worse compliance). The diamond in the middle of each box shows the rate of compliance in the median district.

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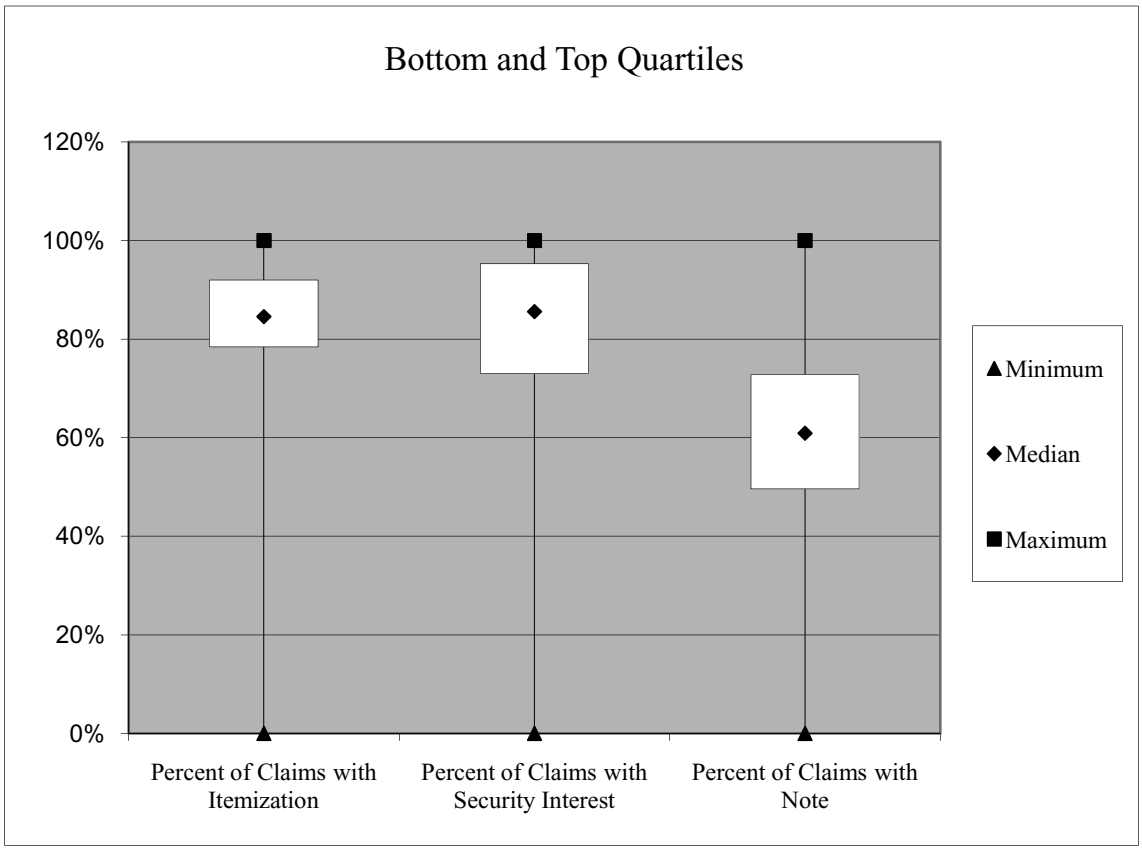
[117] 11 U.S.C. §§ 544 and 548. These provisions are commonly called the "strong arm" powers, because they empower the trustee or other party in interest to "knock off" security interests that are not properly perfected under state law to defeat certain other types of creditors.

[118] Without a security interest, the mortgage is an unsecured obligation and the house is owned free and clear. This not only frees up the house as an asset for the debtor to borrow against in the future, it permits the debtor to discharge any remaining obligation on the mortgage claim after committing all disposable income for the applicable commitment period in the Chapter 13 case.

[119] Fannie Mae/Freddie Mac Uniform Instrument (standard), https://www.efanniemae.com/sf/formsdocs/documents/secinstruments/#standard.

*Figure 2: Variation among Judicial Districts in Attached Documentation*




The least inter-district variation occurred with respect to whether itemizations were attached to claims. While there were outlier districts at both extremes (0% of claims had itemizations and 100% of claims had itemizations), most districts had itemizations attached to between 80 and 90% of the claims. In one in five districts, every claim (100%) had an itemization attached. This was the most consistent compliance rate among the districts, as shown by the relatively short height of the itemization box in Figure 2.

There was greater variation between districts with regard to Rule 3001 compliance. In seven judicial districts, every single claim had a security interest attached. However, in one-fourth of all districts, fewer than 75 percent of all claims had security interests attached. A similar pattern of variation was identified for the attachment of notes to proofs of claims. The major difference was that notes were simply less likely to be attached in the entire sample of districts. Among the districts with the worst compliance with Rule 3001(c)'s requirement that a writing be attached (those in the bottom quartile), the percentage of claims with a note attached was 50 percent or below, ranging all the way to zero complying claims.

The variation among districts reinforces concerns about uniformity, a feature of bankruptcy law that is explicit in the U.S. Constitution's provision permitting a federal bankruptcy law.[120] While uniformity challenges to bankruptcy law have had little success,[121] the variations in proofs of claim reinforce concerns about systematic differences based on where the debtor files bankruptcy. Several academics have observed the effects of "local legal culture" in

[120] U.S. CONST. art. I, § 8, cl. 4; Erwin Chemerinsky, *Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 571, 592–94 (2005).
[121] *See id*. (cataloguing unsuccessful challenges under the uniformity clause).

other aspects of bankruptcy practice;[122] practices with respect to disbursing payments to mortgagees are one example of differences in judicial districts.[123] The proof of claim data reinforce the existence of the existence of the local legal culture phenomenon because compliance with the documentation requirements varies among judicial districts. To the extent that uniformity is a crucial aspect of ensuring the integrity of the bankruptcy system, creditors' inconsistent compliance with claims procedures hinders this goal. Depending on place of residence, debtors and their counsel receive varying amounts of information about mortgage obligations.

The data on proofs of claim show that, at least in one important respect, creditor behavior is not uniform and consistent. Despite clear requirements for documentation that apply in all bankruptcy cases, mortgage proofs of claims do not consistently adhere to applicable law. A majority of claims lack one or more pieces of documentation. This pattern of noncompliance undermines the purpose of the proof of claim rules and effectively shifts the burden to debtors to verify the accuracy of claims. Undocumented or insufficiently documented claims create obstacles to ensuring that families only pay their mortgage creditors what is actually owed and may permit creditors to manipulate the bankruptcy process.[124] The requirements for valid claims should be enforced against creditors to prevent these harms.

**B. Default Fees in Mortgage Claims**

Itemizations were the most common documentation attached to claims. The prevalence of itemizations, however, is misleading. Examination of the itemizations revealed large discrepancies in the quantity of detail provided. No standard format exists for itemizations. Even among servicers, the claims differed in some instances depending on the attorney who was hired to file the proof of claim.[125] The same attorney sometimes filed proofs of claim in several different formats, which could reflect that the servicer itself is preparing the proof of claim and merely transmitting it to the attorney for review and filing with the court.

Inconsistencies in the itemization undermined their usefulness. The itemizations can be a valuable source of information about the nature of the mortgage arrearage that debtors must pay to save their home in bankruptcy. Shortcomings in the detail of information on the itemizations prevent the development of semi-automated or consistent processes for reviewing the charges.

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[122] *See* Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498 (1996); Teresa A. Sullivan, Elizabeth Warren & Jaw Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence From the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801 (1994); Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 AM. BANKR. L.J. 501 (1993).

[123] In many jurisdictions, mortgages are paid "outside the plan," meaning that the debtor continues to make the ongoing principal and interest payments directly to the mortgage servicer, just as before the bankruptcy. Even in these instances, however, the trustee usually collects the debtor's payment of any arrearages on the mortgage loan. Some Chapter 13 trustees require the debtor to make their regular mortgage payments to the trustee, along with the arrearage payments, because they believe that this practice reduces confusion or error and increases the chance that the debtor successfully completes their Chapter 13 plan. Whether a trustee charges a fee to the estate for collecting and disbursing regular mortgage payments also varies between different judicial districts and affects the proof of claim practice.

[124] *See* Opinion Resolving Show Cause Order Entered on March 8, 2007, *In re Wingerter*, No. 06-50120 (Oct. 1, 2007) ("A policy of filing a proof of claim without having possession of the supporting documents, but withdrawing the claim if the debtor subsequently files an objection to the claim's validity smacks of gamesmanship and creates an unacceptable risk that distributions to other creditors will be unfairly reduced.")

[125] In some districts, one or two creditors' counsel dominate local consumer practice, and those firms' itemizations forms seem to be a kind of de facto standard.

For analysis, the Mortgage Study employed several categories for the types of charges that debtors owe,[126] and the fees and charges on each itemization were individually coded in the appropriate category.

Forty-three percent of the itemizations either made reference to fees that did not fit one of the dozen specific categories or proffered an aggregate sum of many types of varying charges that could not be separated. We coded these fees, and the mortgagees' description of the nature of the charges, in an "other" category. These "other" fees were often substantial in amount, but poorly identified.[127] At least three separate concerns appeared from analysis of the fees mortgagees' asserted to be owed in their claims. First, some creditors appear to be overreaching or engaging in unfair practices by asking for patently unreasonable fees. Second, many "itemizations" contain so little detail as to be a perversion of Form 10's use of that term. Third, many proofs of claim requested payment of a "bankruptcy fee," but the permissibility of such a charge is often unclear. Each of these issues is discussed in turn below.

Fees that did not fit an expected category were *per se* suspicious because the categories were deliberately broad (such as "foreclosure costs" and "post-petition") to encompass all common charges that delinquent borrowers incur. As part of the analysis, each of the "other" fees was considered individually. This review revealed dozens and dozens of attempts to collect fees that are likely impermissible, if not illegal. Some of these fees are not "reasonable" as required by the note or state law, are unconscionable as a matter of contract law, or would not withstand an objection by the debtor. Table 1 gives a few examples of causes for concern:

*Table 1: Actual Fees from Mortgagees' Claims*

| **Description** | **Id. No.** | **Fee amount** |
|---|---|---|
| Attorney's fees | WDVA 4 | $31,273 |
| Bankruptcy fees & costs | NDGA 56 | $2275 |
| Broker price opinion fee | ED AR 18 | $1489 |
| Demand fee | DMA 18 | $145 |
| Overnight delivery | EDMI 91 | $137 |
| Payoff statement fee | SDCA 7 | $60 |
| Fax fee | EDVA 21 | $50 |

[126] Each charge was categorized as one of the following: principal, interest, escrow, late charges, foreclosure fees or costs, non-sufficient funds charges, property inspection fees, broker price opinions or appraisals, corporate advances, post-petition fees, suspense funds, or other. The last category was residual and used when the charge did not fit another category or the fees were not broken out into one of the above categories. Our confidence in these categories was bolstered by the recent release of the Model Proof of Claim itemization developed by a joint committee of Chapter 13 trustees and mortgage servicers. *See* Model Proof of Claim Attachment, NAT'L ASS'N OF CHAPTER THIRTEEN TRUSTEES, REPORT OF MORTGAGE COMMITTEE (June 28, 2007) (manuscript on file with author).

[127] For example, one claim's "itemization" listed $5391 described only as "other." (CDCA 12). Another claim requested $3023 for "delinquency expenses." (NDGA 146).

The key point about these suspicious fees is that the proof of claim documentation is frequently inadequate to permit a determination of whether the fees are accurate and legal. In some instances the terms of the transaction may be critically important. For example, at least one court has held that payoff fees are impermissible because they constitute a non-reimbursable expense under the terms of the note.[128] The typical amount of a fax fee ($50) could also be challenged as unreasonable. Such requests are apparently handled autotmatically by fax-back technology at minimal cost to the servicer.[129]

Some notes only obligate the borrower to pay the lender for "reasonable" costs incurred to collect on the debt or enforce the security interest.[130] The standard Fannie Mae/Freddie Mac security interest usually empowers the lender, upon default (including a bankruptcy filing) to "do and pay for whatever is reasonable or appropriate" to protect the lender's interest in the property and rights under the security agreement.[131] The security interest language is quite broad, and makes clear that the listed examples are non-exhaustive. Nonetheless, the fees shown in Table 1 may be neither reasonable nor appropriate; the cited language certainly gives the debtor a basis for investigating the propriety of such fees. The explosion of subprime and alternative loans means that more homeowners have non-standard terms, which has exacerabated the problems created by the lack of claim documentation. Moreover, these fees may be impossible to verify without a payment history for the loan, which almost never was attached to the proof of claim.[132] For example, late charges can be challenged if the payment history shows that they were imposed despite the debtor's check clearing the bank at a prior date.[133]

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[128] *See, e.g.*, Ga. Code Ann. § 7-6A-3 (4) (prohibiting payoff fee or limiting fee to $10 if borrower requests a faxed copy of payoff amount or has other recent payoff requests); Dougherty v. N. Fork Bank, 753 N.Y.S.2d 130 (App. Div. 2003) (holding that payoff quote fee of $100 was not permissible under state law).

[129] LaCour, *supra* note 15, at 192 ("Payoff requests can be handled by incorporating the related fax-back technology, in which printed payoff statements (as would be required for a refinance loan) can be automatically faxed back to a telephone number entered during the same automated telephone transaction.")

[130] For example, one of the mortgage proofs of claim for a case in the Mortgage Study database, MDTN 44, contains the following language, which even specifies that it shall govern any bankruptcy claims filed by the lender: "COSTS OF COLLECTION AND ATTORNEYS' FEES—I agree to pay you all reasonable costs you incur to collect this debt or realize on any security. This includes, unless prohibited by law, reasonable attorneys' fees. This provision also shall apply if I file a petition or any other claim for relief under any bankruptcy rule or law of the United States, or if such person or other claim for relief is filed against me by another."

[131] *See* Fannie Mae/Freddie Mac Uniform Instrument (standard), *available at* https://www.efanniemae.com/sf/formsdocs/documents/secinstruments/#standard ("If (a) Borrower fails to perform the covenants and agreements contained in this Security Instrument, (b) there is a legal proceeding that might significantly affect Lender's interest in the Property and/or rights under this Security Instrument (such as a proceeding in bankruptcy, probate, for condemnation or forfeiture, for enforcement of a lien which may attain priority over this Security Instrument or to enforce laws or regulations), or (c) Borrower has abandoned the Property, then Lender may do and pay for whatever is reasonable or appropriate to protect Lender's interest in the Property and rights under this Security Instrument, including protecting and/or assessing the value of the Property, and securing and/or repairing the Property. Lender's actions can include, but are not limited to: (a) paying any sums secured by a lien which has priority over this Security Instrument; (b) appearing in court; and (c) paying reasonable attorneys' fees to protect its interest in the Property and/or rights under this Security Instrument, including its secured position in a bankruptcy proceeding.").

[132] The instruction on the proof of claim form (Official Form 10) that says that the claimant "must attach to this proof of claim form copies of documents that show the debtor owes the debt claimed" arguably requires not just the note that shows the debtor is in fact obligated on the principal, but the payment history that supports that the debtor actually owes the additional charges.

[133] *See In re Ocwen Federal Bank F.S.B. Mortgage Servicing*, 2006 WL 794739 (N.D. Ill. Mar. 22, 2006) (denying motion to dismiss a multi-district litigation suit that alleged, *inter alia*, that servicer misapplied payments and improperly imposed late fees.).

In other situations, servicers may impose fees repeatedly within a very short time frame. If done without cause and in an unreasonable manner, the imposition of these fees can constitute servicing abuse that may be an unfair or deceptive practice. From the information creditors provided in many itemizations, it was unclear whether the fees represent aggregate costs or single charges. The overnight delivery charge reported in Table 1 illustrates this concern. While it is remotely possible that a debtor could incur a total of $137 in overnight delivery charges over a period of several months, it is exceedingly difficult to determine what bulky and heavy item would incur those charges if they resulted from a single mailing or even how many different mailings must have been made overnight to accumulate $137 in charges. Perhaps the charge reflects a data entry error, and should have been $13, or $17, or $37. The relevant point is that the bankruptcy system did not flag this item as a potential cause for concern and resolve this problem.

Certain charges that may appear on proofs of claim simply are not legal. Some states have regulated the imposition of fees, such as prohibiting the pyramiding of late fees,[134] and promulgated specific rules about the use of suspense accounts to hold partial payments in abeyance.[135] Because mortgage servicers operate on a national basis, they may be unaware of these state laws. Alternatively, servicers may apply the same fees to all loans covered by a securitization pooling agreement, despite the fact that the loans are governed by varying state law. Unless debtors and their counsel object to these claims or obtain a payment history from the servicer to verify these charges, patently unreasonable or illegal fees can pass through the proof-of-claim process and become fixed obligations that debtors must pay to comply with their Chapter 13 plans.

Recently, one bankruptcy court implemented a policy that a certain type of default charge in mortgage claims is not allowed unless the creditor requests an evidentiary hearing and carries its burden. The Honorable Henry Boroff, Chief Judge of the United States Bankruptcy Court of Massachusetts, stated on the record that he is "done allowing lenders reimbursement for property preservation fees," unless the lenders can show "that those property inspections actually happened and that they're worthwhile."[136] Property inspections are the most common type of "property preservation fees;" the other frequent charge is for a broker price opinion, which is essentially an abbreviated appraisal. If the transaction is governed by a standard Fannie Mae/Freddie Mac security instrument, the lender may be limited to making "reasonable" entries or inspections.[137] Presumably, this limitation governs the frequency, as well as the cause, for such activity. The court's presumption against property preservation charges apparently stems from concern that property preservation activity is often unnecessary or unjustified, or that lenders sometimes impose such charges without the occurrence of any actual inspection or appraisal. The Federal Trade Commission's settlement with Fairbanks Capital Corporation

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[134] The Fannie Mae note seems to prohibit pyramiding late fees, stating that the borrower will pay a late charge "only once on each late payment." *See* Fannie Mae, Multistate Fixed Rate Note—Single Family, 6a, *available at* https://www.efanniemae.com/sf/formsdocs/documents/notes/pdf/3200.pdf. Some transactions used different notes (and thus, it is important that a copy of the note accompany the proof of claim), and some servicers may not honor the terms of the notes, either intentionally or inadvertently.

[135] JOHN RAO, ODETTE WILLIAMSON & TARA TWOMEY, NATIONAL CONSUMER LAW CENTER, FORECLOSURES: DEFENSES, WORKOUTS, AND MORTGAGE SERVICING 154–55 (2d. ed. 2007).

[136] Transcript of Hearing at 3, *In re* Waring, No. 06-40614 (Bankr. D. Mass. July 27, 2007).

[137] *See* Fannie Mae/Freddie Mac Uniform Instrument (standard), *available at* https://www.efanniemae.com/sf/formsdocs/documents/secinstruments/#standard ("Lender or its agent may make reasonable entries upon and inspections of the Property.").

explicitly addressed this type of servicing abuse. The settlement enjoined the assessment of property preservation fees more frequently than every thirty days and permitted such charges only if Fairbanks was unable to contact the borrower or had determined that the property was vacant.[138] The amount of the property preservation fees found in the Mortgage Study proofs of claim varied greatly, suggesting either that many of these fees resulted from multiple inspections or that a few servicers may be charging an unreasonable amount for a single inspection service.[139]

Fees imposed during delinquency or in the initial stages of foreclosure can be a substantial source of profit for servicers.[140] The itemizations attached to bankruptcy claims could provide a partial check on this form of servicing abuse, but the lack of a standard form for itemizations inhibits routine review of these charges. The data reveal that suspicious fees do appear on bankruptcy claims. The lack of a note or security interest, both of which are needed to verify the legality of these charges, to accompany the proofs of claims only heightens concern that the bankruptcy system is harboring mortgage servicing abuse, rather than functioning as a system to protect homeowners from impermissible charges.

The second troubling feature of itemizations was the paucity of detail provided. Some itemizations were so minimal as to hardly seemed worthy of that label. In a few instances, the itemization simply consisted of a break-out of the amount of arrears that was part of the creditor's total claim. Since the proof of claim form itself already requires that information, the itemization added nothing to the one-page claim form itself. Other creditors merely listed the total amounts of principal, interest, and "other" or "miscellaneous."

The failure to provide sufficient detail occurred frequently enough to undermine the usefulness of routine inspection of itemizations. More than 40% of claims with itemizations attached listed fees that had to be coded as "other" because the creditors' labels were generic or did not fit any reasonable category.[141] An example of a charge categorized as an "other" fee was the use of the term "pre-petition," without identification of whether these amounts resulted from missed payments, default charges, or accrued interest.[142] This super-generic term does not separate what portion, if any, of the requested amount stems from missed payments and what portion relates to fees and charges. Without a more complete breakdown, a debtor cannot verify that the servicer's claim is correct. A servicer may have misapplied payments,[143] or may

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[138] *See supra* Part II.A. Order Preliminarily Approving Stipulated Final Judgment and Order as to Fairbanks Capital and Fairbanks Capital Holding Corp., United States v. Fairbanks Capital Corp., No. 03-12219 (D. Mass. Nov. 21, 2003), *available at* www.ftc.gov/os/2003/11/0323014order.pdf.

[139] In addition to the example given in Table 1, two different proofs of claim requested payment of property preservation fees of $105 (NDTX 69 and NDTX 75); another property preservation fee was $240 (SDGA 56). As discussed in the text near notes ____, inspection and appraisal were frequently combined in a laundry list of fees, making it impossible to determine whether the inspection or appraisal parts of these charges were reasonable.

[140] *See* Gretchen Morgenson, *Can These Mortgages Be Saved?* N.Y. TIMES (Sept. 30, 2007) ("Borrower advocates fear that fees imposed during periods of delinquency and even foreclosure can offset losses that lenders and servicers incur.")

[141] In the sample of 1484 proofs of claim with itemizations in the Mortgage Study database, 626 claims had amounts that were coded as "other" because no other category applied or the creditor collapsed fees without itemizing the amounts. In addition to the "pre-petition" label, attributes were sometimes made merely to "prior/previous servicer," or simply to "other." In some instances, the amounts were included in a column of summed figures with absolutely no description at all.

[142] Charges or amounts labeled merely as pre-petition were identified in 63 claims, fewer than 5% of all claims. This count excludes any fees labeled to be pre-petition attorneys' fees.

[143] Most loan instruments include language that specifies how payments are to be applied. In Fannie Mae/Freddie Mac Single-family loans, payments should go first to interest and principal before such money is applied to fees.

currently be holding funds in suspense without application to the amount due; either situation inflates the amount of the arrearage. The average amount of debt identified merely as "pre-petition" was $1651, a fairly substantial sum without any specific basis. Further, because any charges that servicers labeled as pre-petition will be included in the determination of the amount of outstanding arrearage that the debtor must pay to cure the default on the mortgage, it is important that the parties verify the veracity and propriety of such charges.

Many itemizations contained laundry-list descriptions, in lieu of one super-generic category. In the Mortgage Study data, the most common such label was "Inspection, Appraisal, NSF, and other charges." Over thirty proofs of claim used that recitation (with the words in that order and no additional fees in that line item). For this description to be accurate, the servicer should have actually conducted an inspection and an appraisal, one or more of the debtor's payments should have been returned for non-sufficient funds, and the debtor should have engaged in some other behavior that resulted in a permissible charge. It is certainly plausible that each of those situations occurred in a single case, but the laundry-list description, particularly the inclusion of "other charges," suggests that servicers are taking shortcuts in describing the actual costs that they bore as a result of the debtor's delinquency.

Anecdotal reports suggest that servicers proffer similarly vague itemizations to borrowers facing state law foreclosure[144]. Given the additional procedural requirements for proofs of claims, the bankruptcy data may understate the information available to nonbankrupt borrowers who want to examine the foreclosure costs that servicers are assessing. The problem may be particularly acute in states that permit non-judicial foreclosure because the creditor does not retain an attorney, who in theory acts as an independent reviewer of the legitimacy of charges.

The final practice of concern was the frequent inclusion of a flat "bankruptcy fee" in the proof of claim.[145] The propriety of this practice is unclear. Some jurisdictions have held that, to the extent these fees are for creditors' attorneys' fees, it is impermissible to include these fees in a proof of claim.[146] These courts require the attorneys for mortgage servicers to file a fee application pursuant to Federal Rule of Bankruptcy Procedure 2016.[147] Other courts have reached a contrary conclusion and permit creditors to include attorneys' fees in proofs of claim.[148] These rulings are inconsistent in their justification, however, leading to further confusion. One court held that Rule 2016 does not apply because the mortgagee's attorneys were not paid directly by the bankruptcy estate but by the mortgage servicer.[149] This approach ignores the reality that promissory notes for residential home loans nearly always obligate mortgagors to pay mortgagees for reasonable attorneys' fees incurred to protect the mortgagor's interest or rights under the security agreement.[150] Other courts have ruled that servicers may disclose attorneys' fees in "most routine circumstances" in a proof of claim, but that the disclosure must

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[144] *See* Morgenson, *supra* note 146 (reporting that a payoff demand statement that Countrywide provided to a borrower had line items identified only as "fees due" and "additional fees and costs" that totaled $8525).

[145] In the remainder of this section, I use the term "bankruptcy fee" as shorthand to describe these fees. I did not include any fees that were identified as related to actual post-petition litigation, such as a motion for relief from the stay or an objection to confirmation.

[146] *See, e.g.*, *Tate v. NationsBanc Mortgage Corp.*, 253 B.R. 653 (Bankr. W.D.N.C. 2000) (ruling that creditor cannot "hide" attorneys' fees for preparing a proof of claim in the claim itself without court approval).

[147] *Id.* at 665.

[148] *See, e.g.*, *In re* Atwood, 293 B.R. 227, 232 (9th Cir. B.A.P. 2003).

[149] *In re* Electra D. Rice-Ethlerly v. Bank One, 336 B.R. 308, 315 (Bankr. E.D. Mich. 2006).

[150] *See supra* Part II.B.

be "specific."[151] Some courts have upheld the prima facie inclusion of attorneys' fees in proofs of claim, but ruled that a fee application is required if the debtor contests the amount or validity of the fees.[152]

If allowed, the issue of what constitutes "reasonable" attorneys fees for a mortgagee in a routine Chapter 13 bankruptcy case applies regardless of whether the fees are included in a proof of claim or disclosed in a Rule 2016 fee application. Several clusters of bankruptcy fees were present; the most common amounts were $125, $150, $250, $275, and $500. On a dollar basis, the difference in these amounts is small. On a percentage basis, however, many mortgagees charge two or three times as much as other mortgagees.[153] Some of this discrepancy could be due to regional differences in attorneys' fees, but the fees seem to vary within judicial districts.[154] Given the minute number of objections to mortgagees' claims,[155] the system appears to permit mortgagees to effectively make their own determinations of what constitutes reasonable attorneys' fees for a routine Chapter 13 bankruptcy filing by a borrower.

Perhaps more disturbingly, a flat bankruptcy fee in a proof of claim may not even represent an actual cost that the mortgagee incurred for hiring counsel to represent it in the debtor's bankruptcy. That is, not only is it unclear what constitutes a "reasonable" fee, these charges may not be for work performed by an attorney. Notably, the claimant did not specify that these fees were "attorney charges" for bankruptcy representation; they could be a "monitoring" fee imposed due to the purported additional burden of having to service a loan for a borrower in bankruptcy. This ambiguity about the source of the expense should be construed against the claimant because it has the information about the charges and has the burden of ultimately proving the amount due. Obscuring the nature of bankruptcy fees worsens the confusion regarding whether disclosure of this fee in a proof of claim is adequate, and does not squarely raise the issue of whether a flat fee, rather than a lodestar fee based on an hourly rate, is a permissible method to calculate the creditor attorneys' fees in a bankruptcy.[156] In some instances, servicers appear to have imposed a bankruptcy fee for the purported administrative costs of preparing a proof of claim.[157] If such work is performed by internal employees and not by

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[151] *In re* Madison, 337 B.R. 99, 103–04 (Bankr. N.D. Miss. 2006); *see also In re* Powe, 281 B.R. 336, 347 (Bankr. S.D. Ala. 2001).

[152] *In re* Plant, 288 B.R. 635, 644 (Bankr. D. Mass. 2003).

[153] A review of the data suggests that in May 2006, when the claims in the Mortgage Study were filed, the bankruptcy fee of Bank of America was $250. Yet, Chase Home Finance, LLC imposed a bankruptcy fee of half that amount, $125. Because these lenders are large, national institutions, presumably their actual costs for preparing a proof of claim would be quite similar. Nevertheless, the data show a disparity. It appears that debtors whose mortgage is held by Bank of America must pay $125 more than debtors whose mortgage is held by Chase Home Finance, LLC in order to complete their plan.

[154] For example, in the Eastern District of Arkansas, bankruptcy fees ranged from $125 and $800.

[155] *See infra* Part III.D.

[156] The lodestar versus flat fee issue was apparently a point of contention in the work of the National Association of Chapter 13 Trustees' committee on proofs of claim. The servicers wrote separately on this issue to argue that a lodestar fee should be permissible, analogizing to the flat "no-look" fee that some courts permit for Chapter 13 representation to avoid debtors' counsel having to file a fee application pursuant to Rule 2016 in each case. *See* Notes by Mortgage Servicers on Mortgage Servicing during a Chapter 13 Bankruptcy at 3–4, Appendix to NAT'L ASS'N OF CHAPTER THIRTEEN TRUSTEES, REPORT OF MORTGAGE COMMITTEE (June 28, 2007) (manuscript on file with author).

[157] This certainly seems to be the situation where the charge was described as "POC prep fee" or "plan review" fee, as was done in a handful of claims. Neither of the prior-quoted activities is strictly necessary to "defend the mortgage," nor are they costs from "prosecut[ing] all necessary claims and actions to prevent or recover for any damage to or destruction of the property." Further, the preparation or filing of a proof of claim and the review of a

licensed attorneys, the corresponding fee cannot be claimed under the "reasonable attorneys' fees" provision of the security agreement or note. Indeed, such expenses can sometimes be characterized as the mere costs of servicing a mortgage that are already compensated for by the issuer's percentage-of-principal payments.[158]

In a modest fraction of cases, mortgagees did not even feel compelled to observe the instruction to attach an itemization to support the total amount they wish to be paid. The more widespread problem, however, is the wide variation in the quality of itemizations. The procedural rule that an itemization be attached to a bankruptcy claim can be a valuable check to the financial incentives of servicers to bloat claims with unreasonable or illegal fees, a phenomenon that has been documented by several courts. Such charges in claims are an affront to the integrity of the bankruptcy system because when payments are made on these amounts through the bankruptcy system, the servicing abuse receives the imprimatur of approval from the bankruptcy court and the trustee program. The requirement of an itemization is meaningless if what is produced cannot be examined in a cost-effective and consistent manner. Without a standard format for itemizations, parties are hobbled in their efforts to assess the propriety of the amount requested in mortgagees' claims.

**C. Discrepancies between Debtors' Schedules and Mortgagees' Claims**

The proof of claim process is the mechanism for fixing the amount of the debtor's obligation. For homeowners in default when they file Chapter 13 bankruptcy, mortgagees normally seek to establish both the amount of the arrearage and the amount of the outstanding principal owed on the loan. These amounts are treated differently in Chapter 13 cases. To retain their homes and enjoy the protection of the automatic stay during the Chapter 13 bankruptcy, debtors must "cure any default within a reasonable time,"[159] normally by making payments over the period of the Chapter 13 plan (three to five years) or a shorter period as fixed by the court in the order confirming the Chapter 13 plan.[160] Any regular mortgage payments on a loan secured by the debtor's principal residence also continue to be due as set forth by the terms of the note. Debtors must have the funds to pay both of these amounts to complete their Chapter 13 plan and receive a discharge of any remaining amounts of unsecured debt.[161] Thus, part of the pre-bankruptcy calculus that debtors and their attorneys should consider in determining whether bankruptcy could permit a debtor to save a home is whether the debtor will have sufficient income to make the Chapter 13 payments.[162] Adequately weighing the viability of Chapter 13 and considering alternatives such as filing Chapter 7 bankruptcy or surrendering the home

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proposed Chapter 13 plan may not constitute an "appearance" by the lender, which is a required prerequisite to the borrower being obligated to pay the lenders' costs and expenses. Yet, these conditions are incorporated in standard mortgage documents upon which lenders rely to collect a bankruptcy fee.

[158] *See* JOHN RAO, ODETTE WILLIAMSON & TARA TWOMEY, NAT'L CONSUMER LAW CENTER, FORECLOSURES: DEFENSES, WORKOUTS, AND MORTGAGE SERVICING 177 (2d. ed. 2007) ("If all the lender is doing is "monitoring" the bankruptcy . . . then these activities do not constitute the practice of law and should not be compensable as an attorney fee. These routine administrative services are generally not compensable under any reading of typical mortgage provisions.") (internal citations omitted).

[159] 11 U.S.C. § 1322(b)(5).

[160] KEITH LUNDIN, 2 CHAPTER 13 BANKRUPTCY § 133.1 (3d ed. 2000) ("It is astonishing and baffling that a significant portion of listed claims are never filed in Chapter 13 cases.").

[161] 11 U.S.C. § 1328(a).

[162] Melissa Jacoby, Symposium, *Consumer Bankruptcy and Credit in the Wake of the 2005 Act: Bankruptcy Reform and Homeownership Risk*, 2007 U. ILL. L. REV. 323, 337 (2007) (arguing that failure of debtors' lawyers to screen their clients for ability to complete a Chapter 13 repayment plan results in more unsuitable debtors in Chapter 13).

outside of bankruptcy requires debtors and their attorneys to have a fairly accurate estimate of the amount of the outstanding arrearage and the amount of the regular monthly mortgage payments.

The bankruptcy court schedules require debtors to provide the total amount of any secured debts and to specify the collateral, the name of the creditor, and the date that the debt was incurred. Based on this information, the Mortgage Study matched each home loan listed on a debtor's schedule D to the corresponding proof of claim.[163] I then measured the extent of the gap between debtors' and mortgagees' calculations of the amount due on the mortgage loan, and analyzed the size and direction of any discrepancies.[164] If the amount on the proof of claim exceeded the home loan debt on the debtor's bankruptcy schedules, I termed the gap in the "creditor's favor." The creditor is asserting that more dollars are owed on the mortgage debt than the debtor believed that she owed. Conversely, if the debt for a mortgage loan listed on a debtor's schedules exceeded the amount on the mortgagee's proof of claim, I termed the gap in the "debtor's favor." In these situations, the discrepancy between the bankruptcy schedules and the claim resulted in the debtor overstating the amount that the creditor believed was owed at the time of the bankruptcy filing.

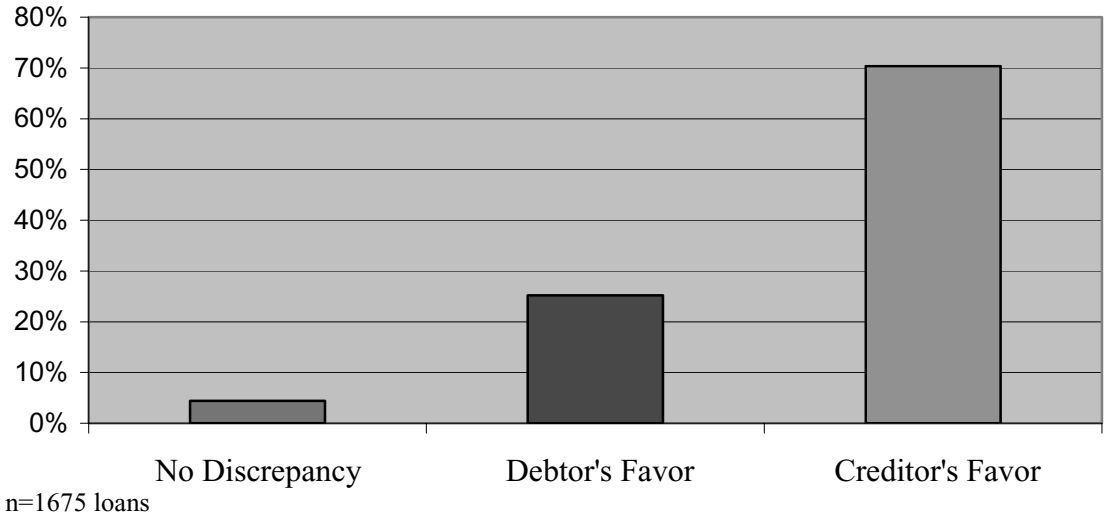
Figure 3 shows what fraction of claims fell into each of three categories based on the existence of a discrepancy between the claim and the scheduled amount of debt. Debtors and creditors agreed on the amount owing for only 74 of 1675 loans (4.4%). For the vast majority of loans (95.6%), the debtor and mortgagee did not agree on the amount of the mortgage debt. In about one-quarter of instances, the debtor set forth an amount of debt in his bankruptcy schedules that exceeded the amount of the mortgagee's claim. These situations are in the debtor's favor, in that the debtor should have been pleasantly surprised at the amount of the creditor's claim. However, the majority of claims contained unhappy news for debtors. Approximately seven in ten (70.4%) proofs of claim asserted that outstanding debt was greater than the amount that

[163] It was not possible to perform this matching for every home loan. Among the 2164 home loans listed on all Schedule D cases in the sample, there were only 1768 proofs of claim filed. No corresponding proof of claim was located for 18.3% of the loans on Schedule D.

[164] For the gap analysis, further loans and their corresponding claims were eliminated from the sample. First, in some instances, the debtor only listed the amount of the arrearage on the Schedule D court record, whereas the creditor's claim was based on the total obligation, including all outstanding principal. In other cases, the opposite phenomenon occurred. The creditor's only claim was for the arrearage that was owed, but the Schedule D listed the entire obligation. Regardless of the direction of the mismatch, these cases were excluded from the gap analysis. Any discrepancy resulted not from disagreement on the actual amount but on a disagreement about what amount (principal, arrearage, etc.) should be included on the schedule or claim; the two parties did not intend to provide equivalent information. In a very, very small number of cases, where both the creditor and the debtor provided only the arrearages (often because local practice or a local claim form directs this result) and this was clear from the documents, the cases were used in this analysis because the gap between the debtor's and mortgagee's records—at least as to the arrearage—can be fairly determined (at least on a percentage basis) based on this information. Second, a small number of outliers (12 loans) were removed because the claims and loans were so discrepant that it appeared that one party was only listing the arrears, despite no actual indication that this was happening. Two criteria were applied to identify outliers. Six loans were eliminated because the gap between the claim and the scheduled debt exceeded 200% of the amount of the scheduled debt. Each of these loans had a gap in favor of the creditor because the claim was much, much larger than the debt. An additional 6 cases were eliminated as outliers because the gap exceeded $100,000 in absolute dollars *and* the gap was greater than 50% of the amount of the scheduled debt. Three of these loans had creditor's favor gaps and three of the loans had debtor's favor gaps. Finally, loans were eliminated if the Schedule D or the proof of claim had a zero or a blank entry for the amount of the debt.

debtors reported on their schedules for that mortgage loan.[165] The gap was in the creditor's favor in these instances.

*Figure 3: Percent of Claims by Type of Gap Between Claim and Scheduled Debt*




n=1675 loans

The findings in Figure 3 evidence that in a vast majority of cases, the debtor and creditor do not agree on the amount of the debt as an initial matter. The claims process provides the mechanism for identifying and reconciling these discrepancies. The mere existence of discrepancies is not itself alarming. The findings in Figure 3 could merely reflect small differences in recordkeeping. Alternatively, the claims could consistently be larger because of the addition of modest and explainable post-bankruptcy charges such as accrued interest.[166] The analysis below explores each of these explanations, ultimately rejecting them as the key reason for the discrepancy between debtors and creditors.

The first indication that the discrepancy results from a genuine and substantial problem in debtors' and creditors' records is the substantial size of the gap in dollars. Among all loans, the median proof of claim exceeded its corresponding debt as listed on Schedule D by $1366. The average proof of claim was $3533 greater than the debtor reported on Schedule D.[167] In the typical consumer bankruptcy, mortgage creditors assert that a significantly larger amount is owed than debtors report on their bankruptcy schedules for a home loan. These errors are too large to reflect small disagreements in recordkeeping, such as a single late charge imposed before the debtor received their mortgage statement.

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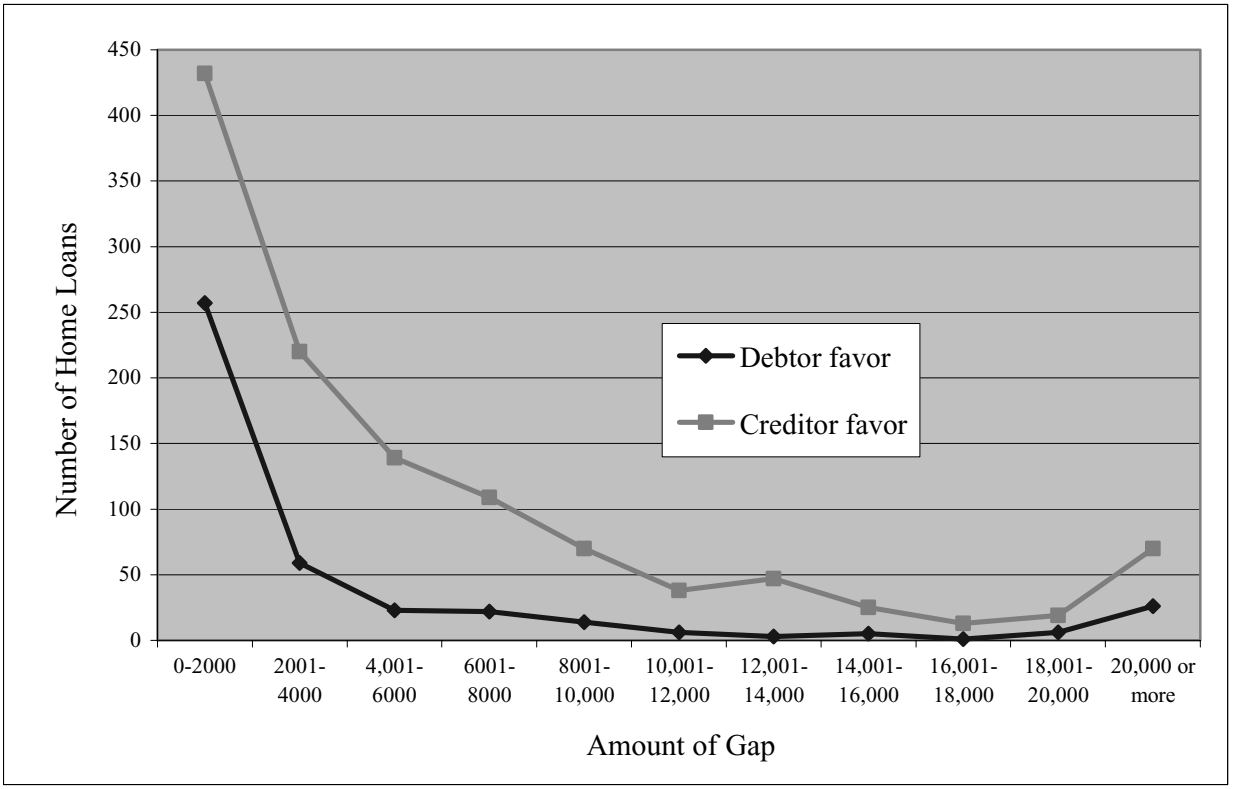
[165] For the remaining 25.2% of loans, the Schedule D listed a greater amount of outstanding mortgage debt than the proof of claim requested. These overestimations were generally more modest, but could deter debtors or their attorneys from pursuing a non-bankruptcy workout with the mortgagee.

[166] The debtor's schedules should only reflect the amount due at the time of the bankruptcy. The proof of claim form should be identical, as the form specifies that the amount listed should be the "Total Amount of Claim at Time Case Filed." However, this instruction to creditors—like those discussed in parts A and B, *infra*—appeared to be frequently ignored.

[167] These statistics are for all home loans used in the gap analysis, including those loans in which the schedule D and the claim matched exactly (gap was zero). N=1675. The standard deviation for the entire sample was 11,480.

The second indication that the discrepancies cannot be explained by minor charges or solely post-petition amounts added to claims comes from subdividing the data for further analysis. Figure 4 shows the distribution of gap amounts between proofs of claim and the corresponding scheduled debts. Postpetition charges can only explain discrepancies in favor of creditors. Debtors have neither the knowledge nor the means to include such charges on their schedules and simply cannot anticipate what these amounts will be with any accuracy.

*Figure 4: Gap Between Proofs of Claim and Schedule D Amounts*




Creditors frequently requested payment on the proof of claim of several thousand more dollars than debtors thought they owed. As illustrated in Figure 4, at every point in the distribution, the number of loans in which the creditor's claim exceed the scheduled amount was higher than the incidence of the reverse situation occurring. The direction of any gap between mortgage claims and the scheduled amounts is much higher in the situations when the gap is in the creditor's favor, i.e., the claim exceeds the scheduled amount.

The median gap for those loans in which the proof of claim exceeded the debtors' scheduled amount (creditor's favor) was $3311. The average gap of $6309 was nearly double the median, indicating some very large discrepancies in the creditors' favor at the tail of the sample, as shown in Figure 4.[168] While the majority of creditor's favor gaps were in an amount less than $4000, the top line in Figure 4 shows that a substantial number of gaps had much higher gaps.

[168] The average gap among the debtor's favor claims was $5376. As with the creditor's favor claims, the size of the average reflects a substantial number of claims with very large gaps. The standard deviation of the debtor's favor claims was 13704. The standard deviation for the creditor's favor claims was 9143.

Large gaps in absolute dollars are more frequent when the discrepancy arises from a proof of claim that exceeds the scheduled amount. When debtors overestimate the claim, the discrepancies are much smaller, rarely exceeding $4000. The median gap for the loans when the discrepancy favored the debtor was $1090, a figure less than one-third the size of median creditor's favor gap ($3311).

Given their size, it seems unlikely that the creditor gaps could result from postpetition obligations. Even if the servicer imposed a bankruptcy fee and interest continued to accrue between the bankruptcy filing and the proof of claim date, the gap is too sizeable to reflect solely postpetition charges. One possibility, discussed *supra* in Part B, is that servicers continue to impose unreasonable fees even after the bankruptcy is filed. Because creditors fail to include itemizations in some cases and provide only general breakdowns of fee categories, it is difficult, if not impossible, for parties to determine the nature of each fee and whether it was assessed prepetition or postpetition.

If the discrepancy does not relate to post-petition expenses, then debtors and creditors simply have different records or lack reliable records. The finding that debtors overestimate their obligations in just over one quarter of loans is consistent with this hypothesis. Debtors are not going to overcharge themselves intentionally; there is no obvious benefit to debtors who inflate the total amount of their home loans on Schedule D.

However, there are policy consequences to debtors' overestimations of even modest amounts. If the mortgagee is actually owed a smaller amount than the debtor thought was due, the counseling process regarding the advisability of bankruptcy was based on misinformation. If the arrearages were significantly less than the debtor thought, viable alternatives could have existed to Chapter 13 bankruptcy.[169] The data do seem to indicate that in many cases, neither debtors nor their attorneys confirm the amount of the mortgage obligations at or near the time of the bankruptcy filing.[170] The substantial number of cases with large discrepancies may reveal serious disagreements between debtors and creditors. These problems could emanate either from serious underestimation behavior by debtors or from inflated claims filed by mortgagees.

Figure 5 presents a different analysis of the discrepancies in the amounts of creditors' claims and the amounts for the corresponding loans on debtors' schedules. For each loan, I calculated the gap as a dollar amount by subtracting the claim and the amount listed for the corresponding loan on the debtor's bankruptcy schedules. I then considered the gap in absolute dollars relative to the amount of mortgage debt as reported on the debtor's schedules. I converted each gap amount to a percent by dividing the gap in dollars by the total amount of the scheduled debt. For example, if a debtor's schedule listed an outstanding mortgage obligation of $100,000 and the corresponding proof of claim was for $110,000, the gap is $10,000. As a percentage of the amount of scheduled debt, the gap is 10%. I then grouped these data into categories based on the size of the percentage that the claim dwarfed the amount on the scheduled debt. Figure 5 displays this analysis for all creditor's favor claims (70.6% of all loans).

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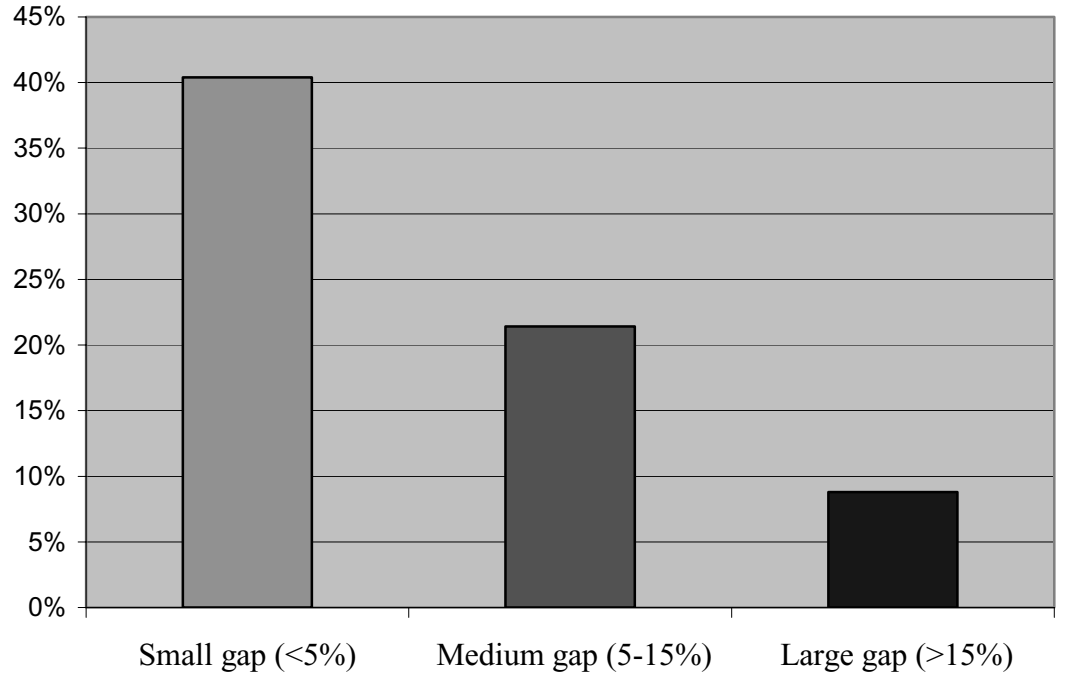
[169] For example, some debtors may have family willing to loan them $500 to cure an arrearage but those same relatives could not come up with $1000 to help. Also, servicers may have greater flexibility in agreeing to workout or forbearance arrangements in situations when the arrearage is small.

[170] Of course, the practices of many servicers themselves deter debtors from getting such information. As explained above in Part I.A, servicers have no reputational concern about poor customer service response because borrowers do not choose their servicer and cannot change their servicer, and so many servicers make it time-consuming and difficult for a debtor to reach them. Additionally, the industry practice of imposing a "payoff" fee discourages debtors from making an account inquiry at the time of their bankruptcy.

Among these gaps in the creditors' favor, when the claim exceeded the scheduled debt, there were different levels of discrepancies. About four in ten (40.4%) of all loans had an amount on the proof of claim that exceeded the corresponding scheduled amount by less than 5%. To some degree, these situations could reflect postpetition charges. However, two points seem worth on this issue. First, mortgage loans are large debts in absolute dollars. Among the "small gap" claims, when the claim was less than 5% more than the amount on the debtor's schedule, the dollars at issue are still sizeable. The average claim in the small gap category exceeded the scheduled amount by $2471. As an absolute figure, this is a significant amount of money for bankruptcy debtors to have to repay, given their relatively modest incomes. A second and related point relates to the costs of default. Even if the gap stems solely from postpetition charges, the 5% additional debt is a powerful reminder of how quickly a defaulted debt can mushroom in size. Proofs of claim are usually filed within 60 days of the date of the bankruptcy filing, but even in this short time, the default charges quickly accumulate to a sizeable sum. To the extent that the claims exceed the scheduled debts due to postpetition charges and fees, the discrepancies evidence the tremendous difficulty that debtors face in curing a default without the help of bankruptcy law to let them do so over a period of years.

The more alarming findings concern the fraction of claims that exceed the scheduled amount by a sizeable fraction. Aggregating the results shown in Figure 5, more than three in ten claims (30.2%) were more than 5% above the debtors' scheduled amounts. Given their size, it seems implausible that these discrepancies resulted from postpetition amounts or an underestimation by a debtor caused by completing the schedules using the prior month's mortgage statement. The fault could come from either party. Debtors may be literally clueless about their mortgage obligations. Creditors may be loading claims with fees that are not permitted in bankruptcy or may be making servicing errors because of confusion caused by the mortgagor filing bankruptcy. Regardless of the source of the misunderstanding, the reality of these situations poses a challenge to the bankruptcy system, which should function to ensure that such disputes are resolved fairly and efficiently.

*Figure 5: Frequency of Creditors' Favor Gaps, Calculated in Size as Fraction of Amount on Claim*




n=1179 loans

Whether viewed in absolute dollars or as a percentage of error, creditors' claims are boosting debtors' obligation in Chapter 13 bankruptcy beyond debtors' expectations. Additional amounts of mortgage debt have meaningful effects on families in bankruptcy. If creditors are overreaching by even half of the amount suggested by either the absolute dollar or percentage analysis, they are imposing a hefty burden on debtors' disposable income and diverting money from unsecured creditors. Even if the proofs of claim are correct, debtors' underestimations of their mortgage debt hamper debtors' attorneys from making optimal *ex ante* determinations about the feasibility of repayment plans. These significant gaps suggest that debtors and their attorneys need to incorporate two additional actions into routine consumer practice. Before bankruptcy, attorneys should obtain an up-to-date statement of their client's mortgage obligations from the creditor before counseling the debtor to file Chapter 13. Then, after a bankruptcy is filed, attorneys and debtors should verify the accuracy and reasonableness of mortgagees' claims, examining the source of any discrepancy between the claim and the schedules.

These findings have implications for the entire bankruptcy system. On an aggregate basis, the discrepancies between debtors and mortgagees are a multi-billion dollar problem. Based solely on the Mortgage Study sample of approximately 1700 loans, millions of dollars may be overpaid to mortgagees.

*Figure 6: Total Gap in Dollars*

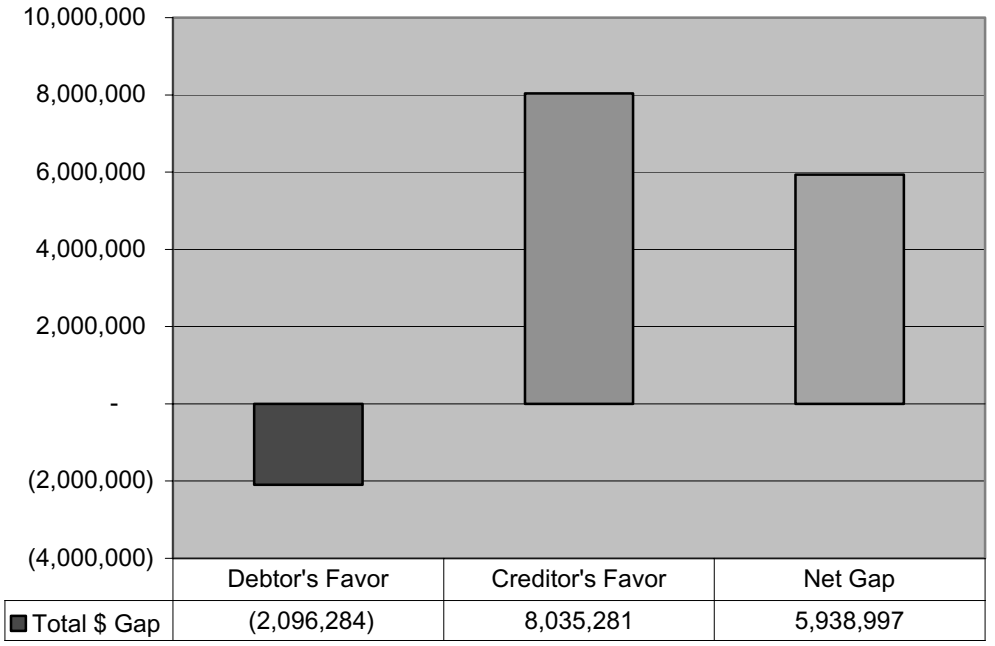



Figure 6 shows combined figures for all of the debtor's favor claims (debtor scheduled a larger amount than mortgagee asserted on the proof of claim) and all of the creditor's favor claims (creditor's proof of claim was larger than the amount of mortgage debt the debtor put on the bankruptcy schedule). When aggregated, the claims totaled millions of dollars—even for the Mortgage Study sample of approximately 1700 loans. When viewed from a systems standpoint,[171] the discrepancies are substantial.

The net effect of these discrepancies favors creditors. As shown in Figure 5, the cumulative effect is that mortgage creditors requested nearly six million dollars more on proofs of claims than the total mortgage debts listed by debtors on bankruptcy schedules. The mismatch between debtors' and creditors' understanding of what is owed tilts sharply toward creditors asserting debts that are greater than debtors believe they owe.

If even a small fraction of this six million dollar net discrepancy represents creditors overreaching in their claims, the damage to the bankruptcy process is significant. Hundreds of thousands of families file Chapter 13 bankruptcy each year and own their homes. Among all these cases, the unresolved differences between debtors' and creditors' records exceed one billion dollars each year. If these mortgage claims are inaccurate, the collective effect on bankruptcy distributions has tremendous policy implications.

Overreaching or errors by servicers impose financial burdens on families trying to buy homes. In the bankruptcy context, such behavior can doom a family's efforts to save its home. Bloated arrearage debts can prevent a debtor from confirming a Chapter 13 plan and force the family to surrender their home. The inadequate documentation of claims, the inclusion of impermissible fees in claims, and the existence of so many claims that greatly exceed the debtors' records each suggests concern about whether mortgage claims are reliable. Very few mortgage claims meet the ideal of the bankruptcy process, despite unambiguous law that is

[171] Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479 (1997).

intended to safeguard the integrity of the claims system. The evidence from the bankruptcy courts calls into question the ability of consumers to trust their mortgage servicers to accurately and fairly account for their payments and assess charges.

**D. Claims Objections**

The data presented in the prior three parts offer multiple indicia that mortgage claims are inaccurate and unreliable. Mortgagees often presented claims without required documentation; many claims contained requests for suspicious fees; and mortgagees' claims and debtors' records were rarely identical. The proof of claim process has an existing, internal mechanism to address such problems. Under section 502(a) of the Bankruptcy Code, any party in interest may object to a claim.[172] If such an objection is made, "the court, after notice and hearing, shall determine the amount of such claim."[173] Claims objections are contested matters, in which the bankruptcy court may hear evidence and make final rulings.[174]

Despite these procedures, mortgage creditors are rarely called to task for the widespread deficiencies or inaccuracies in their proofs of claim. Objections were rarely identified to correspond with the proofs of claim in the Mortgage Study. An objection was filed in response to 4% of all proofs of claim. In numerical terms, among the 1768 proofs of claim in the sample, the total number of objections was only 67. Debtors, trustees, and other creditors simply do not object to mortgagees' claims—even when such claims do not meet the standard for prima facie validity because the claims did not comply with the unambiguous requirements of Rule 3001.[175]

This finding was depressing, but not surprising. Before beginning data collection in the Mortgage Study, Tara Twomey and I spoke to dozens of debtors' attorneys regarding their practices with mortgage claims. With the exception of one or two prominent consumer advocates, virtually no attorney has a routine practice of reviewing mortgage claims.[176] The high-volume nature of consumer practice undoubtedly explains this situation,[177] but does not excuse it. Verifying that debtors only pay amounts to which creditors are legally entitled should be part of bankruptcy representation.

Among the objections that were filed, there were no observable patterns to account for the activity. The objections came from a variety of districts. Twenty-five of the 44 judicial districts had at least one claims objections. In the remaining 19 districts, there was not a single objection to a mortgage claim in our sample. While many districts had only one objection, no district had more than seven objections. It appears that no jurisdiction has a strong local legal culture of reviewing and objecting to claims that distinguishes it from national norms.

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[172] 11 U.S.C. § 502(a).
[173] 11 U.S.C. § 502(b).
[174] Advisory Comm. Notes, Fed. R. Bankr. Proc. 9014 ("For example, the filing of an objection to a proof of claim . . . is a contested matter.").
[175] Fed. R. Bankr. Proc. 3001(f) ("A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim.").
[176] O. Max Gardner III is the most prominent example of a debtors' counsel who has incorporated a review of mortgage claims into his routine bankruptcy practice. Indeed, he has developed a "boot camp" to train other attorneys on the value of this practice. Information is available on his website: http://www.maxbankruptcybootcamp.com/.
[177] A further explanation exists in a few districts, where apparently debtors or their attorneys do not even receive copies of the proofs of claim, which are submitted solely to the trustee. The potential harm of this practice is exacerbated because these districts do not make claims available through PACER, or at least do not do so within the first six months of the case.

Debtors filed more than two thirds of all objections (44 of the 67 objections); Chapter 13 trustees filed the remaining 20 objections. Chapter 13 trustees typically focused on procedural problems with claims. The trustee's most frequent basis for objection was simply that the claim at issue was a duplicate of a previously filed claim. These duplicate claims pose little risk of error in the Chapter 13 mortgage context; the mortgagees' error nearly always will be caught at the time of plan confirmation or when the trustee begins to disburse payments. Trustees tended to catch errors that were either egregious or readily observable. For example, trustees objected when attachments to the claim referenced a borrower other than the bankruptcy debtor, or the claim was filed after the claims bar date.

Debtors filed objections that alleged substantive problems with the claims. The most common objection was a disagreement about the amount of the claim. These situations alleged a variety of wrongs: the claim contained excessive fees; the escrow amount was incorrect; the attorney fees were not itemized; or the mortgagee double-charged for property tax. In a few instances, the debtor contested the arrearages contained in the claim because the debtor believed that the loan was current. This fact pattern has been the source of contention in the cases challenging the creditors' affidavits to support motions for relief from stay.

Neither the few high profile cases about mortgage servicing abuse nor the anecdotal allegations of widespread problems with the reliability of mortgage claims appear to have sparked more scrutiny of claims. Objections were rare in the Mortgage Study sample. The formal objection process for deficient or incorrect claims is largely dormant.

Of course, parties could be informally working out disagreements about bloated claims. To the extent this occurs, the number of objections could understate the amount of scrutiny that claims receive.[178] This hypothesis, however, is incongruent with the rare incidence of amended claims. If creditors were being called to task for inaccurate or incomplete claims through processes like phone calls from debtors' counsel or concerns raised at confirmation hearings, the result in some of these situations should be an amended claim.[179]

The current review of claims is plainly inadequate to ensure the integrity of the bankruptcy system. Sizeable discrepancies between debtors' and creditors' accountings of the amount of outstanding mortgage debt are never reconciled. To the extent that the debtor and creditor disagree on the amount owed, and yet the debtor does not object or even examine the claim, the bankruptcy process may be failing as a mechanism for ensuring the accurate distribution of the debtor's future income. Given that most consumers' mortgage is their largest debt, the claims process may be even less rigorous with regard to other smaller obligations.

The claims process also does not function as a check on mortgage servicing abuse. While this outcome is not an explicit goal of the bankruptcy system, the judicial process should not

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[178] *See supra* note 118.

[179] Another possibility is that the plan confirmation process serves as a check on the accuracy of claims. In their proposed Chapter 13 repayment plans, debtors may be relying on their calculations of the amounts due, rather than using the amount of the mortgagee's claim as the basis for the required repayment. If the creditor does not object to the plan, the order confirming the plan would trump the claim for purposes of the required payment in bankruptcy. Conversely, creditors may be objecting to the amount of mortgage debt in the plan and if the objections are sustained, the plans would be conformed to the creditors' claims. The extent to which confirmed Chapter 13 plans reflect the creditors' claims or the debtors' scheduled amounts or some compromise between this discrepant numbers is an empirical question. The difficulty in testing this hypothesis is that in most districts, the plan contains only the amount of prepetition arrearage. Yet, some claims did not specify the arrearage or combined prepetition and postpetition amounts. Thus, it is impossible to compare the total claim or even the total arrearage between confirmed plans and the proofs of claim in any significant fractionof cases.

implicitly sanction illegal activity. Yet, no objection was filed in response to the claims with the suspicious fees shown in Table 1, *supra*. These claims, like 96% of others, passed undisturbed through the bankruptcy system. While Congress has emphasized the importance of a reliable bankruptcy system that garners the public's trust,[180] creditors face no meaningful consequences when they disregard the law and this public policy.

## IV. IMPLICATIONS

The current interaction between the mortgage servicing industry and the Chapter 13 bankruptcy system is distressing. Many mortgage claims fail to comply with the bankruptcy rules and procedures, assert that suspicious or impermissible fees are owed, or reflect a serious discrepancy between debtors' and creditors' records.

### A. Proof of Claim Process

The problems with mortgage claims are structural. Creditors should comply with federal law if they expect to receive distributions in bankruptcy. Debtors and their attorneys also must bear some responsibility for the malfunctioning of the claims process. Objections to claims do not appear with sufficient frequency to police claims, even with regard to large debts such as mortgages. Quite simply, the current claims process seems broken.

Reforms to the claims process will protect the integrity of the bankruptcy system. As the Supreme Court has recognized, deficiencies in the claims determination process can permit unmeritorious or excessive claims to dilute the participation of legitimate creditors and prevent the just administration of bankruptcy estates.[181] Mortgagees' failure to satisfy Rule 3001 should not be dismissed as a mere technicality. The rules governing claims were implemented to prevent substantive harm. Without documentation of the debt, the other parties in bankruptcy, including the debtor and unsecured creditors cannot verify the legitimacy or accuracy of claims, each of which cuts into the limited pool of dollars available for distribution. The absence of the required documentation effectively deflects creditors' obligations in the bankruptcy process onto cash-strapped bankrupt families, who must choose between the costs of filing an objection or the risks of overpayment. Further, from a systems standpoint, it is hard to discern the benefit of allowing parties to "opt-out" of rules at will.

Mortgagees' frequent failure to comply with Rule 3001 results from weakness in the current rules. Rigorous enforcement of Rule 3001 would improve the fairness and accuracy of bankruptcy payments. Current practice does not deter creditors from disregarding the requirements to attach documentation to Rule 3001. While the rules themselves use mandatory language, phrased in terms of "shall,"[182] the reality is that some creditors treat them as aspirations—or ignore them entirely. In most instances, there is no negative consequence to the mortgagee from its failure to attach the required documentation. Under the current system, the main tool to fight improper claims is Federal Rule of Bankruptcy Procedure 9011, which

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[180] *See supra* Introduction.

[181] Gardner v. State of N.J., 329 U.S. 565, 573 (1947).

[182] Fed. R. Bankr. P. 3001(c) and (d). The proof of claim form (B10) also contains a sheet of instructions, which states, in relevant parts, that "[y]ou must attach to this proof of claim form copies of documents that show the debtor owes the debt claimed or, if the documents are too lengthy, a summary of those documents. If the documents are not available, you must attach an explanation of why they are not available" and "[y]ou must . . . attach copies of the documentation of your lien, and state the amount past due on the claim as of the date the bankruptcy case was filed." Instructions for Proof of Claim Form, Office Form 10[9/97], *available at* http://www.uscourts.gov/bankform/formb10new.pdf.

requires all factual contentions in pleadings to have evidentiary support.[183] While courts have sanctioned creditors for filing unsubstantiated claims,[184] Rule 9011 was not designed to correct the systematic failure of other rules. Rule 3001(f) provides a "carrot" to encourage compliance by granting prima facie validity to claims that are executed and filed in compliance with Rule 3001.[185] Yet, as a practical matter, all claims receive this treatment if neither the debtor nor another party in interest objects to the claim. Creditors can rely on the lack of scrutiny to validate their claims and sidestep the burdens of Rule 3001.

Even when an objection is filed, there is typically no sanction for disregarding Rule 3001 in the first instance. This outcome is the result of the limited legal effect of bankruptcy rules, which "shall not abridge, enlarge, or modify any substantive right."[186] Most courts have concluded that failure to comply with Rule 3001 is not a permissible basis for disallowing a claim because this behavior is not listed in section 502(b) of the Bankruptcy Code.[187] A few jurisdictions have taken a different approach and ruled that incomplete claims documentation can be a basis for disallowing a claim.[188] The majority rule seems to be that a challenged claim that does not comply with Rule 3001 loses its quality as prima facie evidence and shifts the burden to mortgagees to prove their claim. However, courts usually require the debtor to advance some evidence that disputes the claim,[189] so that even if Rule 3001 compliance is lacking, the debtor has some evidentiary burden. If the servicer is uncooperative, and for example, refuses to promptly provide a complete and comprehensible payment history, the debtor may have a difficult time actually forcing the creditor—the party in control of the records—to meet the burden that the rules impose upon it. An affidavit from the debtor may suffice in such cases, and the courts seem to be increasingly sympathetic to debtors' frustrations with obtaining information from mortgage servicers.[190]

The simplest route to boosting the reliability of mortgage claims is to revise section 502(b) to include the failure to provide the attached documentation as a basis for claims disallowance. This reform would ratchet up the consequences for failing to attach a note or security interest. In effect, a creditor, who could not validate the existence of the purported debt

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[183] Fed. R. Bankr. Proc. 9011.

[184] *See, e.g., In re Cassell,* 254 B.R. 687 (B.A.P. 6th Cir. 2000) ("Proofs of claim must meet the standards of [Rule 9011.]"; *In re Berghoff,* 2006 WL 1716299 (Bankr. N.D. Ohio. 2006) (finding that mortgage lender violated Rule 9011 by including certain fees in claim that were not warranted by existing law).

[185] Fed. R. Bankr. Proc. 3001(f).

[186] 28 U.S.C. § 2075.

[187] *See, e.g.*, *In re* Stoecker, 5 F.3d 1022 (7th Cir. 1993); *In re* Heath, 331 B.R. 424 (B.A.P. 9th Cir. 2005); *In re* Gurley, 311 B.R. 910 (Bankr. M.D. Fla. 2001). *See also* Alane A. Becket, *Proofs of Claims: A Look at the Forest* 23-JAN AM. BANKR. INST. L. REV. 10 (Dec./Jan. 2005) (concluding that disallowance on Rule 3001 grounds is not within a court's statutory authority).

[188] *See, e.g.*, *In re* Shaffner, 320 B.R. 870 (Bankr. W.D. Mich. 2005); *see also* WESTLAW BANKRUPTCY LAW MANUAL § 6:4 (5th ed. 2007) ("There is a split of authority on whether the failure to comply with Rule 3001(c) requires disallowance of the claim."). *Cf. In re McLaughlin*, 05-63927 (Aug. 31, 2007) (disallowing claims filed by trustee pursuant to Rule 3004 because trustee did not reasonably investigate claims and provide documentation to support the claims.)

[189] *In re* Campbell, 336 B.R. 430, 434 (B.A.P. 9th Cir. 2005) (holding that a proof of claim that lacks documentation required by Rule 3001(c) is not disallowed unless the debtor's claim objection contests the amount of the debt and not merely the rule violation).

[190] *See In re* Heath, 331 B.R. 424, 437 (B.A.P. 9th Cir. 2005) ("Moreover, a creditor's lack of adequate response to a debtor's formal or informal inquiries in itself may raise an evidentiary basis to object to the unsupported aspects of the claim, or even a basis for evidentiary sanctions, thereby coming within Section 502(b)'s grounds to disallow a claim.") (internal citations omitted).

with a note (or could not adequately explain why a note was unavailable), could not receive more in bankruptcy than it would have been entitled to had it been put to its proof in a judicial-foreclosure lawsuit. In this way, the bankruptcy process would be at least as rigorous as the foreclosure scheme outside of the federal system.

Another strategy is to squarely impose the burden of reviewing mortgage claims on trustees. The Bankruptcy Code already states that a trustee shall "if a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper."[191] Many trustees apparently believe that no purpose would be served by objecting to claims without the documentation required by law. For example, while notes were missing from forty percent of claims, trustees filed only one or two objections that raised that issue.

The U.S. Trustee Program could mandate mortgage claims review as an official duty of panel and standing trustees in their program handbook, and trustees could be evaluated, in part, on their fulfillment of this duty. This solution is informal, requiring no legislative reform. The proposal merely posits that the U.S. Trustee Program would ensure that trustees carry out the statutory mandate in a rigorous fashion. This solution eliminates the need to create incentives for debtors' attorneys to make claims objections in the first instance. The U.S. Trustee Program could use standards and procedures that parallel those used when auditing debtors' schedules. The Chapter 13 trustees could report their activity to the U.S. Trustee Program to generate national evidence of what, if any, problems with claims remain after their active review. This approach could generate more detailed recommendations for legislative reform or show that additional procedures beyond trustee activity are necessary to improve the reliability of claims.

A complementary tactic to these enforcement strategies would improve the clarity of claims. The varying formats and level of detail in the itemizations make it difficult for all parties in interest to make a routine review of proofs of claim. If itemizations were standardized, it would be easier to train legal assistants and junior attorneys to review claims and would facilitate the development of computer programs to help analyze the creditors' calculations for things such as escrow accounts and arrearage payment streams. A model itemization attachment was promulgated by the Chapter 13 trustees and mortgage servicers but the form has not become widely used despite its existence for more than a year.[192] The Advisory Committee on Bankruptcy Rules should review the model itemization and consider incorporating it into the Official Form 10 and Rule 3001(a), at least for mortgage claims. Voluntary adoption of a standard format seems unlikely given the current fate of the model itemization in existence. However, the participation of the servicing industry in creating the model itemization highlights the potential of the existing servicing technology to reasonably accommodate a standard claims format.

The prior solutions would systematically address the issue with mortgage claims.[193] Given the empirical evidence of widespread problems with mortgage claims, these approaches may be the most efficient solution. The realities of consumer bankruptcy practice may dictate structural solutions that do not rely on the voluntary participation of individual actors. While such reforms would modestly increase the administrative burdens, the benefits of increased reliability in mortgage claims justify these policy changes.

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[191] 11 U.S.C. § 704(a)(5).

[192] Model Proof of Claim Attachment, NAT'L ASS'N OF CHAPTER THIRTEEN TRUSTEES, REPORT OF MORTGAGE COMMITTEE (June 28, 2007) (manuscript on file with author).

[193] *Cf. In re* Coates, 292 B.R. 894, 899–900 (Bankr. C.D. Ill. 2003) (noting that frequent appearance of attorneys' fees and expenses in mortgage claims justifies a systematic approach to this aspect of Chapter 13 cases).

**B. Bankruptcy as a Home-saving Device**

Mortgage claims are a key determinant of the outcome of consumer bankruptcy cases. A core function of Chapter 13 bankruptcy is helping families save their homes,[194] which the Bankruptcy Code effectuates by permitting debtors to cure any arrearage on a mortgage over a reasonable time.[195] Because mortgage creditors are most Americans' largest creditor, their actions in bankruptcies heavily influence debtors' success in saving their homes from foreclosure.[196] A family's ability to confirm a Chapter 13 plan or cure a default may turn on the amount fixed as owing to the mortgage creditor.[197] Debtors cannot easily generate additional disposable income if alleged obligations to mortgagees magically increase or if fees multiply without justification. The debtor's ability to pay mortgage arrearages, as a practical matter, determines the success of a case. Not only does plan confirmation turn on this issue, if the debtor misses any plan payments, the mortgage creditor frequently will seek relief from the stay to proceed with a foreclosure and the debtor's bankruptcy may be dismissed. Thus, the amounts of mortgage proofs of claim have direct effects on bankruptcy's usefulness as a home-saving device.

Miscalculations about mortgage debt have grave consequences for families at nearly every point in the bankruptcy system. From the outset, debtors may be harmed if they make the bankruptcy filing decision without correct knowledge of their mortgage debts. If debtors underestimate the amount of their outstanding obligations to mortgagees, which the data show occurs in the majority of cases, their attorneys may misadvise them about the feasibility of confirming a Chapter 13 plan and the likelihood that they can cure their mortgage default. Conversely, if debtors overestimate the arrearage, they could file bankruptcy without pursuing other types of relief, such as borrowing from families or friends, seeking forbearance from the mortgagee, or selling an asset. Debtors' inability to report their mortgage debt with reasonably accuracy indicates a serious shortcoming in the pre-bankruptcy counseling process. The data suggest that attorneys who do not verify the mortgage debt may give suboptimal advice to their clients about the advisability of Chapter 13 bankruptcy. This situation could be one factor that contributes to the low success rate of debtors completing Chapter 13 repayment plans.[198]

After families file bankruptcy, discrepancies in debtors' and creditors' records of the amount of mortgage debt and incomplete mortgagee proofs of claim lead to either of two undesirable consequences. In most instances, the data show that debtors do not verify the amount requested on the mortgagees' claim and risk overpaying that creditor. In so doing, debtors increase their burden in confirming and completing a Chapter 13 plan. This outcome, however, saves the debtor the litigation and negotiation costs of seeking clarification from the mortgagee.

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[194] *See* 1 KEITH LUNDIN, CHAPTER 13 BANKRUPTCY, § 129.1 (3d ed. 2000) ("[I]t is not unusual for rehabilitation of a home mortgage to be the principal reason for filing a Chapter 13 case").

[195] *See* 11 U.S.C. § 1325(b)(5).

[196] Bahchieva, et al., *supra* note 50, at 74. ("Our results also suggest that rising mortgage debt has important consequences for federal bankruptcy policy.").

[197] *In re* Coates, 292 B.R. 894, 899 (Bankr. C.D. Ill. 2003) ("A debtor's obligation to cure the prepetition mortgage arrearage is enforceable as a condition of confirmation. A plan that fails to provide for a complete cure is not confirmable over the objection of the mortgagee. Most of the Chapter 13 cases filed in this District involve the cure of a prepetition mortgage arrearage.").

[198] *See*, *e.g.*, Scott Norberg, *Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13*, 7 AM. BANKR. INST. L. REV. 415, 439 (1999) (finding that approximately one-third of Chapter 13 debtors complete their plans).

When mortgagees' claims are challenged, the debtor faces increased costs for their attorneys' time in this work. Proofs of claim with unexplained or impermissible fees, or without adequate documentation, drive up the expense of bankruptcy relief, a consequence that financially-strapped families can ill afford.

Despite these costs, debtors may benefit substantially from challenging mortgage claims. Bloated claims make it more difficult for a family to confirm repayment plans. Because arrearages must be paid in full, every dollar of savings is a direct benefit to a family who would have to dismiss their Chapter 13 case and surrender its home if the original arrearage amount were allowed to stand. Improved accuracy by mortgage servicers in bankruptcy cases could save litigation costs in response to motions for relief from stay that are based on incorrect accounting. Scrutinizing the proof of claim to ensure that only valid fees are included in arrearage claims can help reduce the burdens that debtors face in making all required Chapter 13 plan payments. Reduced arrearages could improve the success rate of debtors in completing Chapter 13 plans and receiving a discharge. Better outcomes in Chapter 13 could help encourage more debtors to consider this alternative, and boost recovery to all creditors. Further, ensuring that the mortgagees' accounting is accurate at the time of the confirmation can help prevent disputes about the amount of mortgage debt that remains to be paid after the bankruptcy case is complete.

Debtors would benefit substantially if consumer bankruptcy attorneys incorporated a routine review of mortgage claims in the scope of their representation. Given the recent escalation in attorneys' fees that occurred after BAPCPA,[199] it is discouraging to suggest that the solution lies in passing the costs of claims review along to debtors. The structural changes suggested in Part A would reduce the costs of claims review in various ways, and in some instances they would change the incentives of debtors' attorneys to monitor the accuracy of claims.

Taking those suggestions a step further, debtors' attorneys need to be educated about the potential benefits to their practice of challenging mortgage claims. While challenging a claim does not *per se* generate revenue for an attorney, claims review can reveal other causes of action. Most obviously, if consumer attorneys request information from mortgage servicers and receive no response or an inadequate response, the servicer may have violated the Real Estate Settlement Procedures Act ("RESPA"). If successful, these claims entitle plaintiffs to actual damages and the costs of reasonable attorneys' fees.[200] An objection may also generate evidence of a practice that can be challenged under a state's unfair or deceptive practices act, which typically also permits the recovery of attorneys' fees if the plaintiff is successful.[201] In some instances, review of mortgage claims can reveal causes of action that allege violations in how the loan was originated. For example, a review of the Truth-in-Lending disclosure can give rise to a claim for actual or statutory damages, or even rescission of the loan under some circumstances.[202] The Truth in Lending Act also is fee-shifting so that mortgage companies may be ordered to pay the attorneys' fees and costs of successful actions.[203] These examples show how bankruptcy can be

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[199] In 2001, the Consumer Bankruptcy Project found that the median attorneys fee for a Chapter 13 case among five judicial districts was $1550 (in 2001 dollars; no inflation adjustment) (data on file with author). A recent survey suggests that on a national basis, Chapter 13 fees are nearly twice the 2001 amount, with many districts having a presumptively permissible fee of $3000 or more. Nat'l Ass'n of Consumer Bankruptcy Attorneys, Survey of Presumptive Chapter 13 Fees (April 22, 2007) (on file with author).

[200] 12 U.S.C. § 2605(f)(3) (2005).

[201] DOUGLAS J. WHALEY, PROBLEMS AND MATERIALS ON CONSUMER LAW 482 (3d. ed. 2002).

[202] 15 U.S.C. §§ 1635 & 1640 (2005).

[203] 15 U.S.C. § 1640(a)(3) (2005).

the locus for identifying a variety of illegal lending activity. Reviewing mortgage claims should be merely the first step in helping a family stop a foreclosure or untangle itself from the harm of an inappropriate or predatory home loan.

The data provide systematic evidence that mortgage servicers do not adequately document their claims and may be engaged in overreaching in assessing fees and calculating outstanding obligations. The current state of mortgage claims puts debtors at risk. Each time a family loses its home based on an inaccurate claim, the bankruptcy system fails. Inflated mortgage claims undercut a core bankruptcy policy of helping families in financial trouble save their homes and right themselves financially.

**C. Sustainable Homeownership Policy**

The findings on the unreliability of mortgagees' claims have implications beyond bankruptcy. All families who are trying to pay off a home loan are put at risk if subject to poor or predatory mortgage servicing. Most families rely on their mortgage servicer to credit payments, calculate pay-off balances, and apply fees only when justified. Most families do not and cannot separately verify the servicers' accounting. Bankruptcy data provide a lens for examining whether Americans should trust servicers to carry out these tasks and whether the servicing industry is adequately regulated.

As noted above, most Chapter 13 debtors are in default when they file bankruptcy. It seems likely that default by a borrower may exacerbate servicing problems because default triggers the imposition of fees, and sometimes a transfer to a loss mitigation department or even to a new servicer. Nonetheless, the reality is that most defaults and pending foreclosures occur outside the bankruptcy system.[204] Thus, most families who are behind on their home loans do not have the protections—albeit, the existing weak protections—of the bankruptcy claims process to shield them from impermissible or unreasonable default fees. Indeed, servicers' accounting should be better inside the bankruptcy system than outside it because, at least in theory, a bankruptcy is a check on mortgage overreaching. If a Chapter 13 case is filed, the servicer usually hires an attorney who is supposed to review the claim for accuracy and illegality, and the servicer knows that homeowners usually have retained an attorney to represent them. Not only are mortgagees' misbehavior or mistakes probably not confined to bankruptcy debtors, the frightening prospect is that servicing problems among non-bankrupt families who are behind on their mortgages may be even worse than the bankruptcy data reveal.

Poor mortgage servicing is an assault on America's policy of promoting sustainable homeownership. If families are hit with unreasonable fees and cannot understand what is owed on their mortgage loan, they are at risk of foreclosure. Servicing abuse can begin before bankruptcy, but may ultimately drive some families into bankruptcy as a last resort for trying to

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[204] In 2006, there were 597,965 non-business bankruptcy filings in 2006 and 1,259,118 foreclosure filings. *See* Administrative Office of the U.S. Courts, *Bankruptcy Filings Plunge in Calendar Year 2006* (Apr. 26, 2007), *available at* http://www.uscourts.gov/Press_Releases/bankruptcyfilings041607.html (bankruptcy filings); RealtyTrac, *More Than 1.2 Million Foreclosure Filings Reported in 2006* (Jan. 25, 2007), *available at* http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=1855&accnt=64847. The best available data, the 2001 Consumer Bankruptcy Project, indicate that about 52.5% of all families in bankruptcy are homeowners. *See* Bahchieva, Wachter & Warren, *supra* note ___, at 92. Foreclosure filings appear to outnumber bankruptcy cases filed by homeowners by a ratio of four to one. *See also* Dennis R. Capozza and Thomas A. Thomson, *Subprime Transitions: Lingering or Malingering in Default?* 33 J. OF REAL EST. FIN. & ECON. 241–58 (2006) (reporting that only 11% of subprime borrowers in default by 90 days or more subsequently filed bankruptcy in the preceding eight months).

address this issue. The current policy debate on homeownership is focused on loan origination issues, such as whether mortgage brokers or lenders placed families in appropriate loans.[205] Servicing problems may be less visible, but no less harmful. The rising foreclosure rate will only escalate the number of families who must struggle to understand the amount of their arrearage and who are at risk of having to pay unreasonable default costs to save their home.[206] Policies that aim to protect families from foreclosure should address the weaknesses in mortgage servicing, and not just alter the process for loan origination. For families who are already trapped in unaffordable loans, other relief will come too late. Improving mortgage servicing would provide immediate protection to families facing foreclosure.

Paying a mortgage is most families' most important financial obligation. Unreliable servicing can cause ordinary families to overpay, even for those who avoid default and bankruptcy. For example, inaccurate pay-off balances can penalize families when they refinance a home loan. Even families who try to get ahead on their mortgage may lose such benefits if servicers fail to credit additional payments to principal, instead holding them in suspense or treating them as prepayments despite instructions to the contrary from the borrower. These practices create a needless barrier to homeownership.

Under the current regime, consumers have no choice in servicers. Any market exists solely based on the needs of lenders and bond issuers, whose concerns are distinct—if not opposed—to borrowers. Jack Guttentag, emeritus professor at the Wharton School of Business, has suggested that consumers be allowed to "fire" their servicer, essentially receiving a one-time option to choose a different servicer.[207] He postulates that servicers would compete for this additional business, driving up quality, and balancing servicers' incentives between lenders and borrowers. Another policy response to concerns about mortgage servicing is to step up enforcement action. However, single actions against egregious servicers may not produce systematic reform, as the Mortgage Study data suggest that servicing issues are industry-wide. A bigger problem may simply be focusing the Department of Housing and Urban Development ("HUD") on its duties to enforce RESPA and to police mortgage servicers. HUD's website for complaints does not even mention mortgage servicing,[208] and the Federal Trade Commission, rather than HUD, has taken the lead in recent actions against servicers.

The Mortgage Study data suggest that policymakers who focus on promoting homeownership need to concern themselves with mortgage servicing, which is a crucial aspect to enabling families to achieve homeownership. Mortgage servicing abuse weakens families' efforts to manage their mortgages successfully and can result in families being wrongfully deprived of their homes through foreclosure or unsuccessful outcomes in bankruptcy. Mortgagees' failure to honor the terms of their loans and applicable law weakens America's homeownership policies and threatens families' financial well-being.

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[205] Home Mortgage Disclosure Act Data and FTC Lending Enforcement Before the H. Comm. On Financial Services, 110th Cong. 1 5–9 (2007), *available at* http://www.ftc.gov/os/testimony/P064806hdma.pdf (describing FTC collection of data on pricing of subprime mortgages marketed to consumers).

[206] *See generally* RealtyTrac, *Foreclosure Activity Up Over 55% in First Half of 2007* (July 30, 2007), http://www.realtytrac.com/ContentManagement/pressrelease.aspx?ChannelID=9&ItemID=2932&accnt=64847; Danielle Reed, *Rising Foreclosure Rates Point to a Normalizing Market*, REAL ESTATE JOURNAL.COM (Apr. 17, 2006), http://www.realestatejournal.com/buysell/markettrends/20060417-reed.html?refresh=on.

[207] Jack Guttentag, *Borrowers Should Be Able to Fire Mortgage Servicers* (Feb. 2, 2004), http://www.mtgprofessor.com/A%20-%20Servicing/borrowers_should_be_able_to_fire_servicers.htm.

[208] U.S. Dept. of Housing and Urban Dev. Complaints, http://www.hud.gov/complaints/ (last visited Sept. 11, 2007).

The findings are a tangible reminder that merely enacting a law does not ensure its success. Without the correct structural incentives and without robust safeguards, a law can fail to deliver its promised protections. In the consumer context, this observation has particular power. Consumers face disadvantages to industry in a legal system: consumers are not repeat players; they have fewer resources; and they do not have institutional incentives to shape the system. The bankruptcy claims process exemplifies the difficulty in developing and monitoring an effective legal system. The findings should caution policymakers and advocates from blindly trusting in the written law as a decontextualized instrument to shape behavior.

## CONCLUSION

Hundreds of thousands of Americans file Chapter 13 bankruptcy each year hoping to save their homes from foreclosure. Reliable claims are crucial to the success of the bankruptcy system because the claims mechanism implements the two core goals of bankruptcy policy: to help debtors obtain a fresh start by addressing their debts and to ensure that creditors receive a fair share of debtors' assets. From external indicia, the claims process in consumer bankruptcy cases seems like an exemplar of a well-designed legal system that balances the interests of consumers and industry. The claims rules are unambiguous; all parties typically are represented; the process is uniform; the federal judicial system brings gravitas to the procedures; and specialized actors such as bankruptcy judges and trustees are present to police the system.

Yet, despite these reassuring features, the empirical data show that many mortgagees fail to comply with applicable law and, in fact, may be collecting unreasonable or illegal fees in the context of the bankruptcy claims process. These problems damage the integrity of the bankruptcy system and hinder families' efforts to save their homes. The structural incentives in the current system are insufficient to uphold bankruptcy's potential as a home-saving device and to ensure the integrity of the bankruptcy system. Systematic reform of the mortgage servicing industry is needed to protect all homeowners—inside and outside of bankruptcy— from overreaching or illegal behavior. The findings showing the unreliability of mortgage servicing are a high-stakes reminder of the challenges of designing a legal system that actually functions to protect consumers.

AMERICAN BANKRUPTCY INSTITUTE
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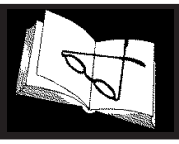
*Issues and Information for the Insolvency Professional*

**Warren & Westbrook on Bankruptcy**



# Class Actions for Post-petition Wrongs: National Relief Against National Creditors

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**Editor's Note:** *This article marks the debut of this column, which will provide scholarly commentary on current issues.*

The use of bankruptcy proceedings as a method of dealing with the inadequacy of class actions to cope with mass torts and other mass claims has become increasingly familiar. A different set of questions is presented by a putative class action to enforce bankruptcy law or to enforce other, closely related laws that are violated during the pendency of a bankruptcy proceeding.

*Prof. Jay L. Westbrook*

These issues are arising more frequently, but have so far received little attention in the literature. A number of recent cases take them on. Of the many issues they raise, this discussion addresses just one: Can the courts certify a nationwide class of bankruptcy debtors injured by the violation of a consumer-protection statute or a violation of the Bankruptcy Code? To put the issue negatively, if a class action under Rule 23 (Rule 7023) is otherwise appropriate, must the class be limited to debtors in cases pending in the district where the action is brought?

These cases can be divided into three categories:

1. Violations of federal consumer-protection laws of general application that overlap with bankruptcy law, especially the Federal Debt Collection Practices Act (FDCPA, as we know and love it);
2. Violations of the automatic stay as against the debtor that are subject to the damage provisions of §362(h);
3. Violations of the discharge injunction under §524, which has no damage provision.

*Prof. Elizabeth Warren*

In all three, the question is whether a nationwide class action can be certified when a defendant creditor has allegedly committed similar violations against many bankrupt debtors around the country. Of course, the usual requirements for a Rule 23(b)(2) or (b)(3) class action must be satisfied, including common relief or typicality, generally. If, for example, the violations are a series of idiosyncratic stay violations differing from debtor to debtor, then there are not the necessary common issues of fact and law. But if a creditor acts consistently against a number of debtors in bankruptcy in a way that allegedly violates one of these statutes, then certification of a class might be appropriate.

This question arises from the debtor-centricity of bankruptcy law. How can nationwide issues be resolved in a bankruptcy court when its jurisdiction is limited to the *res* of a debtor and its *writ* is confined to the district in which it sits? Must the claims be addressed district by district? A recent case in the First Circuit is a good example (*Bessette v. Avco Financial Services Inc.,* 279 B.R. 442 (D. R.I. 2002)). The defendant, Avco, had collected under reaffirmation agreements that were never filed with the court, à la the *Sears* case in Massachusetts. The circuit court had held that a contempt action would lie for violation of the §524 discharge injunction and remanded the case to the district court for further proceedings. 230 F.3d 439 (1st Cir. 2001). On remand, the district court held that class certification must be limited to debtors in Rhode Island, even though Avco is a national company and had apparently applied the practice nationwide. *Accord, In re Beck,* 283 B.R. 163 (Bankr. E.D. Pa. 2002); *Henry v. Associates Home Equity Services Inc.,* 272 B.R. 266 (C.D. Cal. 2002); *In re Cline,* 282 B.R. 686 (W.D. Wash. 2002). This position was strongly endorsed by an article that cited older cases in support of this position and critiqued the cases going the other way. Ball, Corinne and Meises, Michele J., "Current Trends in Consumer Class Actions in the Bankruptcy Arena," 56 Bus. Law. 1245 (2001).

Some other courts have rejected that limitation and certified national classes for alleged nationwide abuses by a particular creditor. *See In re Nolette,* 280 B.R. 868 (Bankr. S.D. Ala. 2001); *In re Powe,* 278 B.R. 539, 280 B.R. 728 (Bankr. S.D. Ala. 2002); *Bank United v. Manley,* 273 B.R. 229 (N.D. Ala. 2002); *In re Sheffield,* 281 B.R. 24 (Bankr. S.D. Ala. 2002); *In re Harris,* 280 B.R. 876 (Bankr. S.D. Ala. 2001), *app. dism., Chrysler Financial Corp v. Powe,* 312 F.3d 1241; *In re Sims,* 278 B.R. 457 (Bankr. E.D. Tenn. 2002).

For example, in *Nolette,* NationsBank (as it then was) added a fixed fee of $125 to each of its claims for the expenses of preparing the claim. The practice was nationwide. The court certified a nationwide class action as to some national issues (*e.g.,* failure to disclose the fee), notwithstanding an argument that adjudication must be on a district-by-district basis.

Three points are central. The first is that it is a mistake to begin the analysis with

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3 This text first appeared at The University of Texas Annual Bankruptcy Conference in November 2002. We express our thanks to Profs. Linda Mullenix and Charles Silver for their advice without implicating them in the result. We also appreciate the research help of Tonya Shotwell, Texas '04.

bankruptcy court jurisdiction. We teach our students to enter the jurisdictional wonderland of bankruptcy always through one gate: What is the bankruptcy jurisdiction of the federal district court? Once that question is answered, then the allocation of function within the federal courthouse can be addressed. Second, the conduct under attack in each category of case is the violation of a federal statute, not a court order. Third, all three are post-petition wrongs against the debtor, not the estate, and therefore are not property of the estate to be administered under §1334(e) of Title 28. *See In re Nolette,* 244 B.R. 845 (Bankr. S.D. Ala. 2000).

## Consumer Protection Violations Against Bankruptcy Debtors

Having those three points in mind, we may start with the simplest case of the violation of a federal statute of general applicability, the FDCPA. A typical FDCPA claim is a direct violation of the FDCPA, as when a collection agency calls the debtor at 2 a.m. It is a violation as to any person, in or out of bankruptcy. FDCPA §805(a)(1). Beyond doubt, the district court has jurisdiction of the claims and beyond doubt could certify a nationwide Rule 23 class, if the other elements of Rule 23 are satisfied. Is there anything about bankruptcy that would require exclusion of bankrupt debtors from such a class? The court might think so, because the FDCPA claim would overlap with a claim under §362(h). That problem could be solved by certifying a separate class (or subclass) of debtors in bankruptcy. The court is simply defining a class. It has no need to look to its bankruptcy jurisdiction at all. Of course, the court may be concerned about the overlap between the FDCPA action and a possible §362(h) claim, but resolution of the interaction between these two federal statutes is simply part of the court's job in such a case. If it is denied the assistance of the bankruptcy court's expertise in such matters, the blame is on our bizarre jurisdictional setup, but this instance is only one anomaly of many in that system.

## Stay Violations

If the debtor is in bankruptcy, the 2 a.m. telephone call also violates §362(a). There is no question but that a stay violation can be the subject of a damage recovery, including punitive damages, under §362(h). But the courts in most of the recent class-action cases have been focused on the status of such a violation as violation of an injunction punishable by contempt. That focus leads them to write that the violation of the stay must be redressed "by the issuing court." *See, e.g., In re Cline,* 282 B.R. 686 (W.D. Wash. 2002). But there is no issuing court. The "injunction" is a statutory provision, not a court order. Its character as an "injunction" is a legal fiction, a point buttressed by the fact that the usual findings for an injunction do not have to be made and the usual notice and a hearing are not needed to bind the entire world. The rationale for the stay is that bankruptcy is a universal proceeding, as the civil lawyers say, or "*in rem,*" as we common lawyers say. But bankruptcy is not merely a property proceeding involving the estate. It protects and discharges debtors and their exempt property as well, so the better description is that bankruptcy is a universal proceeding. Specifically, the stay is not limited to protecting the *rem.* By statute, it also protects the debtor, who is not a thing, against actions to collect a debt. §362(a)(6). Without exploring the other ramifications of that interesting point, suffice to say that §362(h) simply provides the remedy for enforcing a statutory prohibition that protects debtors. Not being tied to the estate, it represents a federal right to be enforced by a federal court. As with any other federal claim (FDCPA, TILA, etc.), any federal court that is the proper venue for the class representatives' claims can certify a class, other requirements being satisfied, that will cover all similarly situated citizens.

Thus, on the face of it, there is no reason to suppose that a federal district court faced with a motion for contempt under §362(h) could not certify a class action if the court concluded that the common questions of law and fact predominated [Rule 23(b)(3), 7023(b)(3)] or that injunctive relief would be the primary relief given the class [Rule 23(b)(2), 7023(b)(2)]. If the violation preliminarily shown is that the defendant's minions made thousands of telephone calls after 9 p.m. attempting to collect debts from bankrupts across the nation, only the specifics of damages would remain to be shown. *Cf. Bolin v. Sears, Roebuck & Co.,* 231 F.3d 970, 979 (5th Cir. 2000) (remanded for consideration of Rule 23(b)(3) certification). The class-action folks have a variety of answers to that problem. Other types of stay violations might require injunctive relief as well. For example, if the only violation is a continuing monthly charge based on failure to disclose to the court an illegal fee, injunctive relief is the only sensible reaction.[4] *See In re Nolette,* 280 B.R. 868 (Bankr. S.D. Ala. 2001). Where the violation consists of an ongoing non-disclosure, it is a direct injury to the integrity of the judicial system, as well as to the debtor and trustee in bankruptcy.

If the action is limited to the §362 violation, there is no intrinsic reason that the bankruptcy court cannot resolve the matter to final judgment, subject to appeal, because stay violations are core proceedings. *See, e.g., In re Sims,* 278 B.R. at 487. In doing so, it is exercising the district court's jurisdiction as it always does, but in this case, it is not its jurisdiction over a particular *rem,* but, as Judge Mahoney put it, over an action *in personam.* 244 B.R. at 849. Because there is no limitation on the district court's power to establish a national class even though venue is proper only with regard to the class representatives, there is no limitation on the bankruptcy court's power to exercise that jurisdiction within the constraints of §157 of Title 28. The concern about "bankruptcy" jurisdiction over a multi-case, multi-district class is a bad pun. The issue is bankruptcy law jurisdiction, not bankruptcy court jurisdiction. As with any other class action, if venue is proper for the class representatives in a particular court, a class can be certified that includes all those claimants who would have been required to bring individual actions in a number of other federal district courts as a matter of venue. There is nothing about the debtor-protection side of bankruptcy that is any different.

Another potential red herring in this jurisdictional analysis is the expressed concern that there are different legal standards in different judicial districts as to various elements of such cases. *See, e.g., In re Peterson,* 281 B.R. 685 (Bankr. E.D. Cal. 2002). If the difference is reasonableness of fees, for example, the concern is justified because geographical variations are differing "facts" requiring individual adjudication. But some of the cases appear to dwell on differences in decisional law on various points. No one has ever suggested that a class action under some other federal statute is barred by differing decisions in various districts as to questions of federal law. The fact that a district court in Mississippi has come to a different interpretation than that found in the Seventh Circuit does not mean a Mississippian has to be excluded from a national class certified in district court in Chicago.

## Violation of the Discharge Injunction

The same analysis applies to §524 and the discharge injunction. Here, there is no right of recovery in the statute, unlike the FDCPA and §362. But there is no doubt that it is enforceable by contempt. *See, e.g., Walls v. Wells Fargo Bank N.A.,* 276 F.3d 502 (9th Cir. 2002); *In re Musselwhite,* 270 B.R. 72 (S.D. Tex. 2001). Given that the explicit recovery right in §362(h) is also enforced by contempt procedures, there is no reason to doubt that similar relief, injunctive

[4] We cannot be sure if the *Bolin* court would agree. *Bolin* may bar injunctive relief for the class. *Bolin v. Sears, Roebuck & Co.,* 231 F.3d 970, 978 (5th Cir. 2000). The opinion in that case is so conclusory on this point it is difficult to tell, especially because Bolin involved a number of different claims, some of them not lending themselves to mass treatment.

and monetary, is recoverable for violation of this statutory provision (another so-called "injunction") as well. Therefore, precisely the same logic should apply to a violation. The closing of a bankruptcy case should not matter, of course, otherwise the discharge injunction would rarely be enforced. Whether it is enforced by the bankruptcy court or the district court is an important detail, but a detail nonetheless.[5]

It may be that growing judicial hostility will doom national class actions generally, but there is no reason they should be denied to debtors in bankruptcy because of confusion about the national scope of bankruptcy law. If national creditors are to escape compensating those whom they have illegally harmed, it should not be on these grounds. ■

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*The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 9,600 members, representing all facets of the insolvency field. For more information, visit ABI World at www.abiworld.org.*

[5] One other point of interest is the intersection of arbitration and bankruptcy as they relate to these issues. The greatest benefit to creditors of arbitration clauses in consumer "contracts" is that they may block class-action treatment of consumer claims. *See, e.g., Randolph v. Green Tree Financial Corp.,* 244 F.3d 814 (11th Cir. 2001) (Truth in Lending violations cannot go forward as a class action because of an arbitration clause), *but, see Green Tree Financial Corp. v. Bazzle,* 351 S.C. 244, 569 S.E.2d 349 (2002), *cert. granted,* 123 S.Ct. 817 (Mem.) (2003) (arbitration may go forward as a class-action arbitration) However, the general rule is that bankruptcy courts have the power to refuse enforcement of arbitration clauses as to core proceedings. *In re Gandy,* 299 F.3d 489 (5th Cir. 2002); *In re Hagerstown Fiber Ltd. Ptshp.,* 277 B.R. 181 (Bankr. S.D.N.Y. 2002). This power was applied this last year to TILA claims. *In re First Alliance Mortg. Co.,* 280 B.R. 246 (C.D.Cal. 2002). Thus, class actions in bankruptcy may offer a solution for debtors' lawyers faced with arbitration clauses that make consumer litigation uneconomic and impractical.

**IN THE UNITED STATES BANKRUPTCY COURT**
**FOR THE SOUTHERN DISTRICT OF TEXAS**
**HOUSTON DIVISION**

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|---|---|---|
| **In re:** | § | **Case No. 05-90374** |
| **WILLIAM ALLEN PARSLEY,** | § | |
| **Debtor** | § | **Chapter 13** |

**FINDINGS OF FACT AND CONCLUSIONS OF LAW REGARDING BARRETT BURKE, COUNTRYWIDE HOME LOAN, INC., AND MCCALLA RAYMER, LLC'S EMERGENCY MOTIONS FOR PROTECTIVE ORDER**
[Docket Nos. 83, 86, 97]

On June 5, 2007, a hearing was held on motions for protective orders filed by Barrett Burke Wilson Castle Daffin & Frappier, L.L.P. (Barrett Burke), Countrywide Home Loan, Inc. (Countrywide), and McCalla Raymer, LLC (McCalla). These motions were filed in the wake of document production requests made by the United States Trustee (UST). This Court has issued three separate orders—one relating to each movant—and set forth below are Findings of Fact and Conclusions of Law relating to all three orders.

## I. Findings of Fact

1. On October 13, 2005, William Allen Parsley (the Debtor) filed a voluntary Chapter 13 Petition. [Docket No. 1.]

2. On October 13, 2005, the Debtor also filed his initial Chapter 13 Plan. This plan listed Countrywide as a secured creditor, secured by the Debtor's homestead. [Docket No. 2.]

3. On February 8, 2006, the Debtor filed his First Amended Chapter 13 Plan. This Plan listed Countrywide as a secured creditor, secured by the Debtor's homestead. [Docket No. 21.]

4. On February 27, 2006, this Court confirmed the Debtor's First Amended Chapter 13 Plan. [Docket No. 23.]

5. On December 29, 2006, Countrywide sought to foreclose on the Debtor's homestead by filing a Motion for Relief from Stay. [Docket No. 26.]

6. On January 22, 2007, the Debtor filed an Objection to the Motion. [Docket No. 27.]

7. On January 23, 2007, and February 6, 2007, this Court held hearings on the Motion for Relief from Stay.

8. On February 6, 2007, at the request of counsel for Countrywide, this Court signed an order withdrawing the Motion for Relief from Stay. [Docket No. 28.]

9. On February 12, 2007, this Court issued an Order to Appear and Show Cause, which required Countrywide and its counsel to appear and show cause why it should not be sanctioned for filing an inaccurate Motion for Relief from Stay containing inaccurate debt figures and inaccurate allegations concerning payments received from the Debtor. [Docket No. 29.]

10. On March 2, 2007, the UST filed a statement regarding this Court's Show Cause Order of February 12, 2007. [Docket No. 40.]

11. On March 5, 2007, this Court held a hearing on its Order to Appear and Show Cause. Certain witnesses testified on this day, and the Court continued this hearing to June 26, 2007. The UST participated at this hearing.

12. On May 18, 2007, this Court issued an Order Regarding Continued Hearing to Be Held on June 26, 2007.[1] [Docket No. 57.] In this Order, the Court expressed concern about various issues concerning the filing and prosecution of the Motion for Relief from Stay, including, among others, which attorney was the attorney-in-charge, why disclosure of this attorney-in-charge was not made pursuant to the applicable local rule, and why this Court was told at the February 6, 2007 hearing that the Motion for Relief from Stay was a "good motion" when in fact it contained inaccuracies.

13. On May 29, 2007, the UST filed Notices of Examination pursuant to Bankruptcy Rule 2004, in order to conduct discovery regarding matters raised in the Show Cause Orders. [Docket Nos. 63-74.]

14. On June 1, Barrett Burke filed a Motion for Protective Order. [Docket No. 83.]

15. On June 1, Countrywide also filed a Motion for Protective Order. [Docket No.86.]

16. On June 4, McCalla also filed a Motion for Protective Order. [Docket No. 97.][2]

## II. Conclusions of Law

### A. Jurisdiction and Venue

This Court has jurisdiction pursuant to 28 U.S.C. §§ 1334, 157(b)(2)(A), and 157(b)(2)(G). Venue is proper pursuant to 28 U.S.C. § 1408(1).

### B. Contrary to the arguments asserted in the three Motions, the U.S. Trustee may conduct discovery through use of Bankruptcy Rule 2004.

[1] This Order, together with the Show Cause Order of February 12, 2007, are hereinafter referred to as the Show Cause Orders.

[2] Together with the Motions for Protective Order filed by Barrett Burke and Countrywide [Findings of Fact Nos. 14 and 15], these motions shall hereinafter be collectively referred to as the Motions, and Barrett Burke, Countrywide, and McCalla shall hereinafter be collectively referred to as the Movants.

All three Motions insist that the UST may not use Bankruptcy Rule 2004 to conduct discovery, but rather must conduct discovery under the Federal Rules of Civil Procedure. This Court disagrees. The Motions selectively cite certain language in Rule 2004 to argue that the Rule only allows examination to discover assets and uncover defalcations. A plain reading of the Rule, however, shows that it allows for discovery on numerous matters:

> The examination of an entity under this rule or of the debtor under § 343 of the Code may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. In a family farmer's debt adjustment case under chapter 12, an individual's debt adjustment case under chapter 13, or a reorganization case under chapter 11 of the Code, other than for the reorganization of a railroad, the examination may also relate to the operation of any business and the desirability of its continuance, the source of any money or property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefor, and any other matter relevant to the case or to the formulation of a plan.

FED. R. BANKR. P. 2004(b) (emphasis added)

In the Show Cause Orders, this Court has raised matters relevant to this case, including: (1) whether the Motion for Relief from Stay was improperly filed; (2) whether Barrett Burke's client is McCalla or Countrywide; (3) why McCalla was not shown on the Motion for Relief from Stay to be the attorney in charge; (4) whether Countrywide has a written policy that it will not assess the borrower—in this case, the Debtor—for attorney's fees and costs incurred for prosecuting a motion to lift stay that is withdrawn prior to the hearing on the motion; and (5) why Walter Thurmond, the attorney from Barrett Burke who appeared at the February 6, 2007 hearing, represented to this Court that the Motion for Relief from Stay was a "good motion" when the testimony of other attorneys at Barrett Burke and at McCalla is to the contrary.

Each of the above issues is a "matter relevant to the case." Given that the public policy for Texas' liberal protection of homesteads is "to protect citizens and their families from the miseries and dangers of destitution," *In re Bradley*, 960 F.2d 502, 505 (5th Cir. 1992) (quoting *Franklin v. Coffee*, 18 Tex. 413, 415-16 (1857); *In re Sorrell*, 292 B.R. 276, 280 (Bankr. E.D. Tex.2002), this Court wants to know why the Motion for Relief from Stay, which sought to foreclose on the Debtor's homestead, contained inaccurate information regarding payments made by the Debtor. Moreover, this Court wants to know why the attorneys who worked on the Debtor's file failed to comply with certain applicable local rules, including (1) Local Rule 11.1,[3] which states that "On first appearance through counsel, each party shall designate an attorney-in-charge. Signing the pleading effects designation"; and (2) Local Rule 11.2, which states that "The attorney-in-charge is responsible in that action for the party. That individual attorney shall attend all court proceedings or send a fully informed attorney with authority to bind the client." Further, the Court wants to know if misrepresentations were made to the Court that all information in the Motion for Relief from Stay was accurate.

The Movants also argue that the UST should not be allowed to conduct discovery under Rule 2004 because the Show Cause Orders constitute a contested matter for which the Federal Rules of Civil Procedure apply. The Movants have also argued that the UST should not be allowed to use Rule 2004 as an aid to develop facts for instituting future litigation against one or more of the Movants. The Court does not find these arguments persuasive. In *In re Mirant Corp.*, 326 B.R. 354 (Bankr. N.D. Tex. 2005), similar arguments were made. The Bankruptcy Court rejected them by noting that:

> As to Respondents' argument that the production ought not to occur under Rule 2004 when it is to aid litigation which is sure to be filed, this requires reliance on case-made law. Rule 2004 contains no exceptions. Generally, when construing a bankruptcy rule, the court should look to its plain language. *Zer-Ilan v. Frankford*

[3] Bankruptcy Local Rule 1001(b) incorporates the local rules of the District Court.

> (*In re CPDC Inc.*), 221 F.3d 693, 699 (5th Cir.2000); *Klesalek v. Klesalek* (*In re Klesalek*), 307 B.R. 648, 652 (8th Cir. BAP 2004) ("It is a settled principle that unless there is some ambiguity in the language of a Bankruptcy Rule, a court's analysis must end with the Rule's plain meaning."). That language is not limited to exclude instances where litigation is, or may soon be, pending, though the drafters of the rule might easily have so provided.

*In re Mirant Corp.*, 326 B.R. 354, 356 (Bankr. N.D. Tex. 2005) (citations and footnotes omitted).

This Court concurs with the holding in *Mirant*. Bankruptcy Rule 2004 contains no language stating that this Rule may not be invoked because of the existence of a contested matter or because testimony from the examination may aid to develop facts for instituting future litigation.

**C. The Movants have failed to meet their burden with respect to most of the document production requests.**

In the Fifth Circuit, the party resisting discovery must show specifically how each request for production is not relevant or how each request is overly broad, burdensome, or oppressive. *McLeod, Alexander, Powel, & Apffel, P.C. v. Quarles*, 894 F.2d 1482, 1485 (5th Cir. 1990); *Merrill v. Waffle House, Inc.*, 227 F.R.D. 475, 477 (N.D. Tex. 2005). With certain exceptions, the Court finds that the Movants have failed to meet this burden.

McCalla has persuaded this Court that the UST's Request Numbers 6 and 20 are either too broad or go beyond the scope of the matters raised in the Show Cause Orders; therefore, McCalla will not be required to produce the documents requested in these two Requests. Further, with respect to Request Number 16, McCalla has persuaded this Court that the Request could require production of voluminous documents; therefore, McCalla will not be required to produce these documents but will only be required to produce a list of those cases presently pending in the Southern District of Texas in which McCalla retained any local counsel in Houston under the same terms of engagement as the retention terms in the Parsley case with the Barrett Burke law firm.

Barrett Burke has persuaded this Court that the UST's Request Numbers 16 and 21 are either too broad or go beyond the scope of the matters raised in the Show Cause Orders; therefore, Barrett Burke will not be required to produce the documents requested in these two Requests. Further, with respect to Request Number 19, Barrett Burke has persuaded this Court that the Request could require production of voluminous documents; therefore, Barrett Burke will not be required to produce these documents at this time, but will only be required to produce a list of those cases presently pending in the Southern District of Texas in which Barrett Burke was retained by McCalla under the same terms of engagement as the retention terms in the Parsley case, for the period January 1, 2005 through February 6, 2007.

Countrywide has persuaded this Court that the UST's Request Number 5 could require production of voluminous documents; therefore Countrywide will only be required to produce retainer agreements, engagement letters, and/or contracts between Countrywide and the McCalla Law Firm concerning pending cases in this Court for which McCalla has retained local counsel in Houston and forbidden such counsel to communicate directly with Countrywide.

## III. Conclusion

Pursuant to *Chambers v. NASCO*, 501 U.S. 32 (1991) and 11 U.S.C. § 105(a), this Court issued the Show Cause Orders under its inherent power to police the conduct of the attorneys and parties who appear before it. As noted above, this Court is concerned about a creditor—in this case, Countrywide—seeking to foreclose on a homestead by filing a motion to lift stay containing an inaccurate payment history. Under 11 U.S.C. § 307, the UST may appear and be heard on any issue in any case—and that includes appearing and being heard on matters raised in the Show Cause Orders.

The UST is entitled to conduct discovery pursuant to Bankruptcy Rule 2004, and the Movants must comply with the production requests made by the UST except those specific requests addressed above.

Signed on this 6th day of June, 2007.

Jeff Bohm
U.S. Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NORTH CAROLINA

| | |
|---|---|
| In Re:<br><br>SAMUEL E. SMITH, and<br>MELINDA D. SMITH,<br><br>Debtor(s). | Case No. 00-31220<br>Chapter 13 |
| SAMUEL E. SMITH and wife, MELINDA D. SMITH, MICHAEL E. THOMAS and wife, TRINA E. THOMAS, and ALL OTHER PERSONS SIMILARLY SITUATED,<br><br>Plaintiff(s),<br><br>v.<br><br>TMS MORTGAGE, INC.,<br><br>Defendant(s). | Adversary Proceeding<br>No. 00-3148 |

ORDER
(1) DENYING MOTION TO DISMISS;
(2) DETERMINING THAT CLASS ACTION MAY NOT BE MAINTAINED, and
(3) GRANTING JUDGMENT FOR INJUNCTION RELIEF FOR PLAINTIFFS

This matter is before the court on defendant's Motion to Dismiss plaintiffs' Complaint, which challenges defendant's practice of adding a $125 charge to its Proofs of Claim for the cost of preparation thereof. A hearing on the present motion was conducted before all three of the bankruptcy judges of this

District because the issues raised in this adversary proceeding had appeared, and would continue to appear, in other proceedings in each of this court's divisions. Based upon the motion, the hearing, and the record in this matter, the court on its own initiative has determined that this adversary proceeding could and should be concluded at this time without further motions, discovery or trial. Consequently, for the reasons that follow, the court has determined that: (1) Defendant's Motion to Dismiss should be denied; (2) the class action should not be maintained; and (3) the plaintiffs are entitled to judgment for injunctive relief (including reasonable attorneys' fees) by which defendant should be ordered (a) to cease its practice of adding a $125 fee to its Proofs of Claim filed in this District and (b) to refund all such funds collected in cases presently pending in this District.

1. Motion to Dismiss

The defendant has asserted that the plaintiffs lack standing to bring this action (constitutional and statutory) essentially because they do not have a direct financial stake in the outcome of the action. This argument is based on a misconception of the nature of a Chapter 13 bankruptcy case and the mechanics of that reorganization process. The ultimate fact in these cases is that

the debtors' money is being paid to their creditors, and they have a sufficient stake in insuring that their debts are properly paid to satisfy standing requirements.

Standing is an "irreducible constitutional minimum" necessary to make an Article III "case" or "controversy" justiciable. Lujan v. Defenders of Wildlife, 504 U.S. 555, 560 (1992). The standing test requires the plaintiff to satisfy three elements: (1) injury in fact to the plaintiff; (2) causation of that injury by the defendant's complained-of conduct; and (3) a likelihood that the requested relief will redress that injury. Id. The party invoking the federal jurisdiction has the burden of proving the standing test. See FW/PBS, Inc., v. Dallas, 493 U.S. 215, 231 (1990).

The debtor-plaintiffs here have suffered harm sufficient to meet the "injury-in-fact" element of the standing test. The debtors have been making payments to the Chapter 13 Trustee, and the Trustee has been distributing those payments to creditors, based in part on the proofs of claim that were filed in their cases. The Proof of Claim filed by defendant TMS included a $125 fee that TMS added to its Proof of Claim for its cost of preparation. So, part of what is being paid to TMS by the Trustee from funds paid by the debtors is this $125 fee. Despite the fact that this is a small amount of money, it does in fact have a

financial impact on the debtors. Less tangibly, but just as important, the debtors have a real interest in insuring that their debts are paid properly. Overpayment to one creditor impacts the debtors' repayment scheme and could result in extension of the debtors' Plans of reorganization or delay in receipt of their discharge.

In short, TMS' action is an "invasion of some legally protected interest which is concrete, particularized and actual or imminent, not merely conjectural or hypothetical." Lujan, 504 U.S. at 555. This is not a situation in which the debtors are attempting to assert the rights of a third party. Compare Sierra Club v. Morton, 405 U.S. 727, 740 (conservationist organization, absent evidence that organization or members would be affected in any of their activities or pastimes by proposed building of recreation area in natural game refuge, lacked standing to pursue injunction and declaratory relief).

The causation element of the standing inquiry is readily satisfied from the conclusion that the debtors have suffered a concrete and particularized harm. This is because TMS' action of placing this $125 line item attorney fee provision in its Proof of Claim is the direct cause of the economic harm to the debtors.

Similarly, the relief sought by the debtor-plaintiffs is designed to redress the specific injury alleged.

Consequently, the plaintiffs have satisfied the constitutional prerequisites of standing to bring this action, and defendant's Motion to Dismiss on that account should be denied.

With respect to the plaintiffs' statutory standing, defendant asserts that Section 549 of the Bankruptcy Code provides that only the "trustee," and not the debtor, shall have power to avoid post-petition transfers of estate property. Thus, defendant asserts that only the Trustee has statutory standing to bring this action. While Section 549 is one mechanism to avoid a post-petition transfer, no provision in the Code states that it is the exclusive means. To conclude otherwise (as defendant suggests) would produce untenable results: For example, the court, the Trustee and creditors have an interest in insuring that only the proper sums are paid to each creditor. To assume that Section 549 is the exclusive remedy would imply that other creditors could not object to the overpayment of defendant even though the payments came at their expense. Nor could the court act sua sponte to stop paying an unlawful charge -- even though Section 105 provides that the court can do anything necessary to carry out the provisions of the Bankruptcy Code. As noted above, the debtors have a real stake in

this action, and the Bankruptcy Code provides a remedy for the debtor. See Tate v. NationsBanc Mortgage Corp., 253 B.R. 653, (Bankr. W.D.N.C. 2000). Consequently, defendant's motion to dismiss must be denied.

2. Class Action Determination

The plaintiffs' Complaint (as amended) seeks to state claims for a class of individuals who have filed bankruptcy petitions in the Western District of North Carolina from whom the defendant has claimed a "bankruptcy fee." Bankruptcy Rule 7023(c) provides that the court must determine whether such a class action may be maintained:

> (1) As soon as practicable after commencement of an action brought as a class action, the court shall determined by order whether it is to be so maintained.

In order for an action to be maintained as a class action it must meet the prerequisites of Bankruptcy Rule 7023(a) and one of the criteria of 7023(b)(1)-(3).

While the prerequisites to maintaining a class action may be satisfied here, the court has concluded that this action should not be maintained as a class action for the following reasons:

(a) Each and every member of the putative class is already engaged in an independent bankruptcy action involving the

defendant. By the definition of the class, each "member" is a petitioning debtor in a bankruptcy case in this District. The relief sought involves claims filed by defendant in those independent cases. Thus, the putative class members are parties already engaged in existing independent "litigation" with the defendant, and are already represented in such bankruptcy cases by attorneys who they have engaged themselves (except for the few debtors proceeding pro se).

(b) The ultimate progression of a class action would culminate, after a "Stage I" trial of the class action, at "Stage II" in a series of individual determinations of relief to individual class members. The existing individual bankruptcy cases of each of the class members present a virtually identical forum -- at this time. So, future "Stage II" proceedings in a class action would merely duplicate presently existing proceedings -- and only after the effort and expense to all parties of the Stage I class action proceeding.

(c) The class action is not necessary here because the court can issue an Order that would have class-wide effect in the absence of a class action. The defendant's conduct for which relief is sought took place in proceedings pending before this court. The definition of the putative class demonstrates that defendant's

assessment of its "fee" was done in bankruptcy cases pending in this court. Consequently, it would be appropriate for the court to enter an Order for injunctive relief in this individual case which had effect as a general rule in other cases pending in this District. Such an order would effect "class-wide" relief without the burden of the class action (and any purely individual claims could be determined in existing individual cases).

For those reasons, the court has concluded that in these circumstances a class action is not a necessary, efficient or appropriate vehicle for resolution of the issues raised in this proceeding. Consequently, the court has determined that this action may not be maintained as a class action.

3. Judgment For Relief

The court is aware that determination of the merits of a proceeding prior to the defendant filing its Answer is generally not appropriate. But, it appears that actions such as the present one are becoming somewhat epidemic, that they are taking on the nature of a holy war, and most important, that the issue here is something that should be handled in the nature of an administrative matter regarding the administration of bankruptcy estates in this District.

The defendant has stated in its supporting Memorandum the only facts necessary to the determination here: That the plaintiffs have filed Chapter 13 bankruptcy cases in this District and that defendant filed a Proofs of Claim in their cases that included an "item in the amount of $125 specifically and visibly denominated 'Attorneys fees and costs.'" Memorandum In Support, p. 2. And, the court can note from this record that defendant has not filed a separate application for such fees and costs.

The Bankruptcy Code contains no authorization for entitlement to fees and costs against the estate by a creditor other than pursuant to an application pursuant to Section 506(b). Norton Bankr. L. & Prac. 2d, § 123:14 states that:

> Creditors in some districts routinely add a fixed fee to their proofs of claim in Chapter 13 cases to cover the cost of preparation and filing of the proof of claim itself. Because there is no provision in the Code, other than Section 506(b), for allowance of attorney fees incurred post-petition, these fees should not be allowed unless they can properly be allowed under 506(b).

This and similar cases present a number of subsidiary issues which are not determinative. Whether the "fee" for preparation of the Proof of Claim is identified as such or not, whether it is generated internally by the creditor's employees or "out-sourced," whether the cost represents the work of a professional or a non-professional, there is no authority for the assessment of any such

fee other than an application pursuant to Section 506(b) of the Bankruptcy Code. Anything other than such an application is not authorized and is not permitted.

The court is of the opinion that normally no fee or cost for preparation of a Proof of Claim is appropriate. Normally preparation of the Proof of Claim involves the simple task of filling in a few blanks on an official form. Unlike a formal pleading, it does not require an attorney's signature, and certainly does not require any professional expertise to prepare it. There may be extraordinary situations in which the preparation of the Proof of Claim is sufficiently complex to require a professional to prepare it. In such situations, the proper procedure would be to file an application for the fee or cost pursuant to Section 506(b) and Bankruptcy Rule 2016.

For the above reasons, defendant's practice of adding the $125 fee to its Proofs of Claim is improper. The appropriate remedy in these circumstances is to order the practice to cease, to require modified Proofs of Claim and to require reimbursement of amounts improperly collected by defendant.

There has been nothing alleged in this action to indicate that these plaintiffs have been injured beyond the payment of part of the $125 fee assessed or that punitive damages are appropriate.

The Complaint alleges no consequential damages or injury other than the fee itself. Further, no basis for punitive damages has been alleged or shown in any way. But, because there may be situations where such actual or punitive damages might be appropriate, the court does not believe it should foreclose such claims in appropriate cases. Consequently, the court has determined to deny such relief here without prejudice to individual claims for such injury that go beyond the mere assessment of the fee.

The court believes that it is not necessary or appropriate for this action to proceed any further for determination. The court has concluded that it is appropriate for it to enter a judgment (a) granting relief for ~~the plaintiffs~~ including an order requiring defendant to cease ~~its practice~~ its practice of assessing a fee for preparation of Proofs of Claim in this District, requiring reimbursement of any such ~~fees it~~ has been paid in pending cases in this District, and paying reasonable attorneys' fees to these plaintiffs' attorneys ~~(to be determined upon application by them)~~; and (b) denying any other relief sought (without prejudice to claims for actual damages and punitive damages, other than for the fee itself, by individual debtors in their own bankruptcy cases). This Order is also without prejudice to defendant ~~for~~ any creditor

in other cases) filing an application for fees and costs pursuant to Section 506(b) and Bankruptcy Rule 2016 where appropriate.

4. Conclusion

As a matter of information, the court notes the following about the "method to its madness." This Order is a final Order and a separate Judgment will be entered contemporaneously with it so that any (or all) parties may appeal to the District Court. The court in the Tate case will enter an Order from which the parties may appeal and seek joinder with any appeal in this case. The court is informed that there are presently pending in this District five other similar actions. The court will schedule status conferences in those cases in order to explore the application of the rule in this case to those cases. Finally, the court will enter an Administrative Order consistent with the ruling in this case which will apply to all cases in this District prospectively.

The ruling in this case reflects the opinion of each and all of the bankruptcy judges of this District and it will be applied as consistently as possible by each judge in each division. The parties are requested to cooperate with the Chapter 13 Trustee to effect the relief ordered here in as efficient manner as possible.

The court is open to suggestions regarding implementation of the relief if that is necessary.

It is therefore ORDERED that:

1. The defendant's Motion to Dismiss is denied;

2. The plaintiffs' prayer to maintain this action as a class action is denied;

3. The defendant, TMS Mortgage, Inc., is ordered: (a) to cease immediately the practice of including a charge for preparation of the Proof of Claim in Proofs of Claim filed in the Western District of North Carolina; (b) to file an amended Proof of Claim in each pending case in the Western District of North Carolina where such charge was included, which amended Proof of Claim shall eliminate such charge; and (c) to reimburse to the Chapter 13 Trustee in each pending Chapter 13 case in the Western District of North Carolina the amount of any such charge that it has received;

4. The defendant, TMS Mortgage, Inc., shall pay to plaintiffs their reasonable attorneys' fees, which the court will determine by Supplemental Order upon filing of application for fees by plaintiffs' attorneys;

5. Except as stated in paragraphs 3, 4, and 5, plaintiffs' claims for relief in their Complaint are denied; and

6. The parties are directed to cooperate with the Chapter 13 Trustee to implement this Order.

George R. Hodges
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF ALABAMA
SOUTHERN DIVISION

| | | |
|---|---|---|
| In re: | * | Case Nos. 97-10511-MAM |
| | * | Chapter 13 |
| ROCKY DWAYNE SHEFFIELD, | * | |
| | * | |
| Debtor, | * | |
| | * | |
| ROCKY DWAYNE SHEFFIELD, | * | |
| | * | |
| Plaintiff, | * | |
| | * | Adversary No. 99-1124-MAM |
| v. | * | |
| | * | |
| HOMESIDE LENDING, INC., | * | |
| | * | |
| Defendant. | * | |
| | * | |

AFFIDAVIT REPORT OF PROFESSOR TODD J. ZYWICKI

I, Todd J. Zywicki, being duly sworn on oath, do depose and state as follows:

1. I am an Associate Professor at the George Mason School of Law in Arlington, Virginia. I have been employed full-time as a law professor since 1996. In that time, I have taught courses in bankruptcy, contracts, secured transactions, business associations, and other aspects of commercial law. Consumer bankruptcy law has been a focus of my academic work.

2. I am the author or co-author of over 25 scholarly articles and essays in law reviews and economics journals. My articles on bankruptcy law have appeared in numerous leading journals, including the *Wisconsin Law Review*, the *Bankruptcy Developments Journal*,

DEFENDANT'S EXHIBIT 13

the *Journal of Bankruptcy Law and Practice*, the *BYU Law Review*, and the *Annual Survey of Bankruptcy Law*. I have been invited to present my scholarship at a number of law schools, including the University of Virginia School of Law, Notre Dame University School of Law, Emory University School of Law, University of Georgia School of Law, and the University of Colorado School of Law. I also was selected to participate in the *Chapman Law Review's* "Rising Stars in Bankruptcy Law" Symposium this past year.

3. I have testified three times before subcommittees of the United States House and Senate on issues of consumer bankruptcy law and bankruptcy reform. I have lectured before Congressional staffers on bankruptcy law and policy and provided briefings to them on bankruptcy reform issues. I also rendered assistance and advice to the National Bankruptcy Review Commission and to Commissioner Edith H. Jones, of the U.S. Court of Appeals for the Fifth Circuit.

4. I am a Contributing Editor to the *Norton Bankruptcy Treatise* and Co-Chair of the Federalist Society's Bankruptcy Subcommittee of the Financial Services and E-Commerce Practice Groups. I am also a frequent media commentator on issues of bankruptcy and commercial law, including appearances on *The Newshour with Jim Lehrer* and columns and commentary in *USA Today* and *the Christian Science Monitor*.

5. I am a graduate of the University of Virginia School of Law. I also hold a Masters degree in economics from Clemson University and an undergraduate degree from Dartmouth College. Prior to entering academia, I practiced bankruptcy law for two years with the firm of Alston & Bird in Atlanta, Georgia. In the course of that practice, I represented Paccar Financial as a secured creditor in consumer bankruptcy cases. I am admitted to practice law in

Georgia, and the United States District Courts for the Northern and Middle Districts of Georgia and the United States Court of Appeals for the Fifth Circuit.

6. In July, I was approached by attorneys for HomeSide Lending, Inc. ("HomeSide") about serving as a possible expert witness in this case. I was hired on August 1, 2000. The terms of my representation were confirmed in writing in a letter from HomeSide's counsel dated August 23, 2000.

7. The task assigned to me was to conduct research regarding the applicability of a certain school of bankruptcy scholarship, known as "local legal culture," to the types of fees challenged in Mr. Sheffield's Complaint.

8. The concept of "local legal culture" is well-established in the scholarly literature of consumer bankruptcy law and practice. See e.g., Report of the National Bankruptcy Review Commission at 233-36 (Oct. 20, 1997), *available at http://162.140.225.1/consum.pdf.* It is perhaps best summarized in Professor Jean Braucher's observation that, "the Bankruptcy Code is federal law, but consumer bankruptcy law in action is local. Each bankruptcy court has its own official and unofficial practices. . . . Individual lawyers assimilate this local culture to varying degrees. In a sense, there is a consumer bankruptcy law of each city, even of each law office." Jean Braucher, "Lawyers and Consumer Bankruptcy: One Code, Many Cultures," 67 *American Bankruptcy Law Journal* 501, 502 (1993).

9. The persistence and pervasiveness of local legal culture with respect to the consumer bankruptcy system results in substantial differences in both the substantive interpretation of the Bankruptcy Code and how it is applied in practice in bankruptcy courts across the country. Indeed, as Professor Braucher suggests, not only does legal interpretation and administrative practice differ among districts, but they may even be inconsistent within a

given district, according to the Division within the District, the Judge presiding over a given case, or the Chapter 13 standing trustee administering the case.

10. Professor Braucher's findings regarding the existence and persistence of local legal culture have been mirrored by other scholars writing both before and after her. In their path-breaking book, *As We Forgive Our Debtors*, Teresa Sullivan, Jay Westbrook, and Elizabeth Warren found that local legal culture in the bankruptcy system exerted a strong effect on the substantive and procedural operation of the consumer bankruptcy system. *See* Teresa A. Sullivan, Elizabeth Warren, and Jay Lawrence Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* 246-256 (1989) ( "We believe that the 'uniform' system of bankruptcy laws is in fact very different in different courts, so that the debtors in one area and those in another encounter distinct legal systems."). In their follow-up study, these authors found substantial differences among local legal cultures even *within* the same state. Sullivan et al., "The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts," 17 Harvard Journal of Law & Public Policy 801, 828 (1994). They concluded that "local legal culture exercises a pervasive, systematic influence on the operation of the federal bankruptcy system in ways unanticipated by lawmakers or academic researchers." *Id.* at 806.

11. Braucher, as well as Sullivan, Warren, and Westbrook, identify the interactions of bankruptcy judges, local Chapter 13 trustees, and practicing attorneys as the primary source of local legal culture.

12. Although these previous studies documented the existence and persistence of local legal culture, they primarily focused on issues of chapter choice by consumer bankruptcy debtors, namely the variables that influenced a debtor's decision to file in Chapter 13 versus

Chapter 7. None of these studies addressed the question that has arisen in this case, namely whether the model of local legal culture also exists with respect to interpretations of substantive legal rules and bankruptcy practice regarding an oversecured creditor's collection of bankruptcy-related fees and expenses. My study was designed to attempt to answer that question.

13. In order to conduct my study, I followed the prevailing methodology used by other scholars who have investigated local legal culture. Prior to my deposition, I interviewed approximately 35 bankruptcy professionals from around the country.

14. By telephone, I interviewed a nationwide cross-section of Chapter 13 standing trustees and their counsel, creditors' attorneys, and debtors' attorneys. My inquiries focused mainly on Chapter 13 standing trustees (hereinafter "trustees"), as I expected them to have the most comprehensive and neutral knowledge of prevailing local practice. *See* William C. Whitford, "The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy," 68 *American Bankruptcy Law Journal* 397, 410 (1994) (using data supplied by National Association of Chapter 13 Trustees).

15. Consistent with the prevailing methodological practice used by local legal culture scholars, my interviews were loosely structured, consisting of open-ended questions about consumer bankruptcy practices. *See* Sullivan et al., "Persistence of Local Legal Culture," *supra* at 839-40; Sullivan et al., *As We Forgive Our Debtors*, *supra* at 351-53. Braucher, *supra* at 512-13 (interviews consisted of "non-directive, open-ended questions, not always phrased the same way or asked in the same order" ).

16. In my interviews, I was not seeking to elicit any opinions regarding the propriety or impropriety of particular practices. Indeed, as I stated in my deposition in this case, I have not considered the issue of the propriety or impropriety of particular practices. My investigation was

limited to collecting information about prevailing legal practices around the country and synthesizing that information in the context of rendering an opinion regarding the existence of local legal culture on the issues described. The information I sought from the interview subjects was purely descriptive and not normative.

17. On September 15, 2000, my deposition was taken by the plaintiffs' attorney, Steve Olen.

18. At the deposition, I provided Mr. Olen with the tentative opinion that I had formed as a result of my research to that date. That opinion was tentative because, at the time, my research and interviews were ongoing.

19. In addition, I knew at the time that I was an expert offered in connection with class certification issues. Thus, I was aware of the fact that I might be asked for an opinion on other issues depending on what plaintiff filed when he filed his class motion on October 2, 2000. I have not been asked to consider any additional issues since that brief was filed, so I have no new opinions.

20. The opinion that I provided to Mr. Olen was that, based on my then-current research and a reasonable degree of certainty, and consistent with the local legal culture literature, there is a similar degree of non-uniformity in legal interpretation and practice around the country with respect to the ways that oversecured creditors collect fees and costs associated with a bankruptcy proceeding. Likewise, I provided the opinion that there is not uniformity in the legal interpretation or administrative practice with respect to the collection of these fees. I still hold these opinions today. The grounds for my opinion are found in the summaries of my interviews, which are contained in my deposition transcript and that testimony. The facts and

data I based these opinions on were of a type reasonably relied upon by those experts conducting research and forming opinions in this field.

21. Subsequent to my deposition, I continued the same interview process and completed my research. In all, I conducted approximately ten additional interviews, mostly with debtor's counsels and trustees. A copy of my interview notes is attached as Exhibit 1. In addition, I followed up with some of my previous interview subjects in order to ask additional questions and to seek clarifications.

22. There are, in fact, significant differences in the manner in which oversecured creditors collect their fees and costs arising from bankruptcy. In some instances, these differences are reflected in the local rules or standing orders of the various bankruptcy courts throughout the country. In other instances, the differences are reflected by different practices adopted by judges and trustees within the various districts.

23. Often, the variations in the manner in which such fees are collected reflect more fundamental differences in the ways in which different bankruptcy courts interpret the Code and administer their cases.

24. For example, in some districts, only a mortgagor's arrearage is paid through the plan, and ongoing payments are made outside of bankruptcy. It is my understanding that this is how Rocky Sheffield's mortgage debt was handled. In other districts, the entire mortgage balance is paid through the plan. There is a similar split in the way these fees are collected. In some bankruptcy courts, these fees are added to the arrearage and paid out through the plan. In other courts, the fees are tacked on to the mortgage balance and paid outside of bankruptcy.

25. Similar differences abound. Where there are discrepancies between the debtor's plan and creditors' proofs of claim, in some courts the trustee "pays to the plan," while in others

the trustee "pays to the claim." In other courts, the trustee only pays to an order of the Court. In the District of Kansas, for instance, the trustee reviews all of the proofs of claim and files a motion for their allowance. Thus, no money is paid out under a plan except pursuant to a specific order of the bankruptcy court. One trustee from the Southern District of Texas also reported that he only paid to an order of the court.

26. In some districts, the trustees actively review and object to claims. In others, judges play the lead role. Others place the primary responsibility for such a review on the debtor's counsel.

27. The differences in each approach, or combination of approaches, has influenced the method by which oversecured creditors collect fees. For instance, the procedure followed by HomeSide in the Sheffield case, that is, to file for attorneys' fees by listing them on the proof of claim itself, is permitted by the Standing Order of the Chapter 13 Trustee for the Southern Division of the Eastern District of Tennessee. In other bankruptcy courts, the Trustee's Offices referred me to published decisions and other court orders that recognize this practice. See e.g., In re Legasse, 71 B.R. 551 (D. Conn. 1987) (awarding $2800 in bankruptcy attorneys fees over debtor's objection). In the District of Massachusetts, however, Local Rule 2016-1 appears to require a separate application to be filed for § 506(b) fees. Other districts set floors for fee requests, below which no formal application is even permitted.

28. Each of these procedures is in many ways a product of the various local legal cultures found in bankruptcy courts across the country. As discussed above, each bankruptcy court differs in the manner by which it administers claims in bankruptcy. Each bankruptcy court also faces different cases mixes and case loads which put varying strains on their dockets.

29. The documentation and substantive work required from creditors' counsel also varies from court to court. The reasonableness of the fees depends, to a great deal, on the work required and local market conditions. Indeed, how courts and trustees evaluate the reasonableness of a fee varies widely and in many ways reflects the varying approaches to how courts approve the compensation of debtors' counsel. Some establish bright line rules and do not generally object to or reject claims that are below a certain threshold. Others scrutinize the work done and the fee charged in each particular case. The dollar range for what is deemed reasonable also varies widely.

30. As many of the practices and procedures adopted in the various bankruptcy courts are mutually exclusive, it would be impossible to adopt the same standard nationwide without overruling local rules, standing orders, case law and customs already in place in bankruptcy courts across the country.

31. Further support for this opinion can be found in my deposition transcript at pages 101-137, 149-161, 183-87, 190-216, 223-25, and 231-39 and at Exhibits 126, 127, 129 and 130, which contain a summary of my research and interviews. In formulating my opinion, I also relied on the local legal culture literature, the published local rules of various bankruptcy courts, as well as standing orders and case law identified by various Chapter 13 standing trustees.

32. The information that I received in the interviews that I conducted after my deposition was entirely consistent with the results of the research that I conducted prior to September 15th. For instance, I found additional variations regarding the manner in which proofs of claim are served. Some bankruptcy courts have adopted local rules that require all proofs of claims to be served on debtor's counsel. In other courts, service is effected on debtors' counsel solely as a matter of local custom. Not surprisingly, the degree to which these local rules

and customs are enforced and the penalties for their violations also vary. In other courts, proofs of claim are not served on the debtor's counsel, but in many of those courts, access to the proofs of claim is often available through the Internet or other electronic means.

33. Now that my research is complete, I stand by the opinions that I expressed at my deposition and set forth here at paragraph 20.

34. I am being compensated for my time, except for time spent testifying at depositions and/or court appearances, at a rate of $225 per hour. I am being compensated at a rate of $275 per hour for depositions and court appearances.

35. I have not testified as an expert at trial or by deposition in the last four years.

36. I have authored or co-authored the following publications within the last ten years:

**BANKRUPTCY**

*With Apologies to Screwtape: A Response to Professor Alexander*, 9 J. BANKR. L. & PRACTICE 613 (2000).*

Book Review Essay, BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES, 16 BANKR. DEV. J. 361 (2000).

*The Economics of Credit Cards* 3 CHAPMAN L. REV. 79 (2000) (Selected to participate in Chapman Law School "Rising Stars in Bankruptcy" symposium).

*Rewrite the Bankruptcy Code, Not the Scriptures: Protecting a Debtor's Right to Tithe in Bankruptcy*, 1998 WISCONSIN L. REV. 1223 (1998).

*It's Time for Means Testing* (with Judge Edith H. Jones), 1999 BYU L. REV. 177 (1999).

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* Indicates Peer-Reviewed Publication

I declare under the penalties of perjury under the laws of the United States of America that the foregoing is true and correct. Executed this 6th day of October, 2000.

Todd J. Zywicki

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